UNIVERSITY OF CAPE TOWN

FACULTY OF COMMERCE

DEPARTMENT OF FINANCE AND TAX

‘A CRITICAL ANALYSIS OF THE TAXATION OF CROSS-BORDER SERVICE FEES IN SOUTH AFRICA: MOTIVATION FOR THE RE-INSTATEMENT OF THE WITHHOLDING TAX ON SERVICE FEES.’

SUBMITTED TO THE FACULTY OF COMMERCE

in partial fulfilment of the requirements for the degree of MCom (South African Taxation)

UNIVERSITY OF CAPE TOWN

Mbali Xulu (XLXMBA002)

Supervisor: Martie Foster, Department of Finance and Tax, University of Cape Town

DECLARATION

I, **Mbali Dumisile Xulu** , hereby declare that the work on which this research paper is based is my original work (except where acknowledgements indicate otherwise) and that neither the whole work nor any part of it has been, is being, or is to be submitted for another degree in this or any other university.

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‘Changes in communications and technology have created new industries where the performance of extensive and profitable business activities does not require substantial machinery or equipment, or establishment at one specific geographical point for a long period of time. The conclusion is that the effects of the [permanent establishment] concept in international fiscal law have changed, in particular during the last few decades. Rather than protecting the tax base in the source state, the [permanent establishment] principle today has become instrumental in ensuring avoidance of source-state taxation for some economically important business operations … [and] the future is likely to prove that the [permanent establishment] principle has lost its force for new and mobile industries, whether treaties are renegotiated for this purpose or not.’[1]

[1] Pinto, D., 2006. The need to reconceptualize the permanent establishment threshold. *Bulletin for International Taxation*. 60(7):266–279. Available: International Bureau of Fiscal Documentation (‘IBFD’) [20 January 2018].

ABSTRACT

South Africa has seen a growth in cross-border services in the last decade. This comes as no surprise since, as early as 2010, the global service sector accounted for approximately 70% of the world's Gross Domestic Product.[2] Given the magnitude of the service sector, it is imperative that South Africa implements laws that seek to tax service fees in an efficient, effective and equitable manner.

South Africa's Minister of Finance and the Davis Tax Committee are amongst the key government stakeholders who have expressed concern regarding the threat that South Africa faces to the erosion of its tax base as a result of outward cross-border service fees.[3] The tax base erosion typically occurs when a non-resident derives a service fee from South Africa which is not taxed in South Africa, whilst the resident payor is allowed to claim a deduction.

As a means of addressing the above threat, South Africa introduced the withholding tax on service fees regime.[4] This withholding tax was intended to apply on service fees derived by a non-resident from a source in South Africa.[5] However, as the application of this withholding tax was subject to the application of the relevant double tax treaties, South Africa's right to impose this withholding tax was in most cases limited.[6] The withholding tax on service fees regime was therefore repealed.[7]

With the withdrawal of the withholding tax on service fees, South Africa can only tax service fees to the extent that they are derived by a non-resident from a source in South Africa and attributable to the non-resident's permanent establishment situated in South Africa.[8] In terms of the Organisation for Economic Co-operation and Development Model Tax Convention[9] ('OECD MTC'), a permanent establishment is defined as essentially comprising of a fixed place of business whilst, under the United Nations Model Tax Convention[10] ('UN MTC'), this definition is extended to include the provision of services by a non-resident who is at least present in South Africa for more than 183 days in any 12-month period rendering services in connection with the same or connected project.

Globalisation and electronic commerce has made the remote provision of services possible. It has therefore become relatively easy for a non-resident business to render services in South Africa without

[2] The World Bank. 2013. Available: http://data.worldbank.org/indicator/nv.srv.tetc.zs [9 February 2018].
[3] Explanatory Memorandum on the Taxation Laws Amendment Bill ('Explanatory Memorandum'), 2013. 2013. Available: http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2013-02%20-%20Explanatory%20Memorandum%20Taxation%20Laws%20Amendment%20Bill%202013.pdf [8 February 2018].
[4] Taxation Laws Amendment Act, No. 31 of 2013. 2013. Government gazette. 582(37158). 12 December. Government notice no. 1001. Cape Town: Government Printer. Available: http://www.sars.gov.za/AllDocs/LegalDoclib/AmendActs/LAPD-LPrim-AA-2013-02%20-%20Taxation%20Laws%20Amendment%20Act%202013%20GG%2037158.pdf [9 February 2018].
[55] Explanatory Memorandum, note 3, p.76.
[6] As at 11 July 2017, only 12 out of 78 effective South African double tax treaties contained Articles which could potentially enable South Africa to impose a withholding tax on service fees. See Annexure A.
[7] Taxation Laws Amendment Act, No.15 of 2016. 2016. Government gazette. 619(40562). 19 January. Government notice no.40. Cape Town: Government Printer. Available: http://www.sars.gov.za/AllDocs/LegalDoclib/AmendActs/LAPD-LPrim-AA-2017-03%20-%20Taxation%20Laws%20Amendment%20Act%2015%20of%202016%20GG%2040562.pdf [25 February 2018].
[8] To the extent that there is a valid double tax treaty between South Africa and the non-resident service provider's country of tax residence.
[9] Organisation for Economic Co-operation and Development ('OECD'). 2015. Model Tax Convention on Income and on Capital, 2014 (full version) ('OECD MTC'). OECD Publishing, Paris. Available: http://dx.doi.org/10.1787/9789264239081-en [26 February 2018].
[10] United Nations ('UN'). 2011. Model Tax Convention between developed and developing countries, 2011 ('UN MTC'). Available: http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf [26 February 2018].

the presence of a fixed place of business or without being present in South Africa for substantial periods and thereby avoid being subjected to income tax in South Africa on the service income derived.

In light of the above, this dissertation argues that the permanent establishment threshold is no longer appropriate for the taxation of services. Specifically, it is contended that the permanent establishment threshold is excessively high and as a result contributes towards the erosion of the source state's tax base. Various options for addressing this concern are then explored and a recommendation is made that South Africa should negotiate for the inclusion of the technical fee article in its double tax treaties and re-instate the withholding tax on service fees regime.

ACKNOWLEDGEMENTS

I would like to thank my creator, the God Almighty, for His love and for giving me the strength and ability necessary to complete this dissertation. His grace is sufficient for me.

Secondly, I would like to thank my supervisor, Martie C. Foster, for her guidance, encouragement and support. You provided me with meaningful insights and advice during times of uncertainty. Thank you.

Last, but not least, I would like to thank the following people by dedicating this dissertation to them:

My mother – how do I begin to thank you? You have done so much for me, that no words could capture how grateful I am for what you have done for me. I thank God for choosing you to be my mother and for giving you the wisdom and strength to raise me. Thank you for raising me to fear God and for teaching me the importance of education. Your passion for learning inspires me to continue to develop myself professionally.

My soon-to-be husband – thank you for loving me and giving me the space to pursue my dreams. I could not have asked God for a better partner than you. You are patient, understanding and supportive - I really appreciate you for that. I pray that this journey that we are embarking on together can be filled with love, laughter, support for one another and patience and understanding.

My family and friends – thank you for your understanding and patience throughout the period that I was working on this dissertation. I hope that my achievement will inspire you to reach for greatness, just as your personal achievements have inspired me to do the same.

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1.1 Background

The pressure to maximize profits and increase shareholder value has led to more and more entities conducting their business on a global scale. The global markets offer multinational entities the opportunity to *inter alia* increase their market share, access to cheap labour and access to advanced technologies.

Africa is considered an emerging market and most multinational entities in pursuit of growth opportunities look to setup operations in this market. In this regard, South Africa is considered the more advanced economy in comparison to most of its African counterparts and a gateway to the rest of the continent. It is therefore no surprise that South Africa has seen an increase in cross-border transactions since it rejoined the global economy after the democratic elections in 1994.

South Africa's tax-to-GDP ratio for the 2014/2015 fiscal period was recorded at 25.7% with corporate taxes being the third largest contributor.[11] However, South Africa faces a threat to the erosion of its tax base due to the increase in outbound payments, particularly relating to non-goods transactions.

In its interim report on addressing base erosion and profit shifting in South Africa, the Davis Tax Committee comment as follows with regards to the outflow of payments recorded between 2008 and 2011:

> … it appears that nearly 50% of all payments flowing out of the country relates to legal, accounting and management consulting services. This classification is followed by copyrights, royalties and patent fees, which also showed significant growth over the same period…
>
> …The magnitude and prevalence of cross border non goods transactions are clear. It poses a serious threat to the fiscus insofar as tax revenue, and is an indication that illicit tax base migration through avoidance schemes and practices could be taking place. The magnitude of the transactions, although always expected to be large, is material and constant reviews in respect of assurance interventions and tracking should become the norm…[12]

Addressing tax base erosion resulting from outbound cross-border service fees

In an effort to address the potential tax base erosion resulting from outbound cross border service fees, the National Treasury and the South African Revenue Service ('SARS') have embarked on various initiatives aimed at identifying and collecting revenue from non-resident taxpayers who provide services of a technical, managerial or consultative nature from a South African source that fall outside the normal tax net.

In the 2013 Budget Speech, the Minister of Finance tabled a proposal to introduce a withholding tax on service fees.[13] The withholding tax on service fees was subsequently introduced into legislation by

[11] National Treasury and SARS. 2015. *Tax Statistics*. Available: http://www.treasury.gov.za/publications/tax%20statistics/2015/TStats%202015%20Inside%20WEB.pdf [9 February 2018].
[12] Davis Tax Committee Interim Report ('Davis Tax Committee'). 2014. *Addressing Base Erosion and Profit Shifting in South Africa*. (Chairman: D. Davis). Available: http://www.taxcom.org.za/docs/New_Folder/1%20DTC%20BEPS%20Interim%20Report%20-%20The%20Introductory%20Report.pdf [9 February 2018].
[13] Gordhan, P., 2013. National Budget Review. Available: http://www.treasury.gov.za/documents/national%20budget/2013/review/FullReview.pdf [9 February 2018].

the Taxation Laws Amendment Act No. 31 of 2013.[14] The following reasons were provided for the introduction of this tax:[15]

> Lack of cross-border withholding taxes on management/technical fees
>
> Unlike most developing countries, South Africa does not have a withholding tax on management or technical fees. Like interest and royalties, these fees generate local deductions, thereby giving rise to potential base erosion. Internal data suggest that these fees amount to billions per annum, much of which is shifted to low-tax jurisdictions. Hence, some form of protection in the form of withholding is needed to protect the tax base as has already been enacted for cross-border interest and royalties.
>
> Taxation of permanent establishments
>
> The current nexus between taxation under normal tax versus 15 per cent withholding is partially inappropriate. While the permanent establishment test is an international standard, OECD principles suggest that normal taxation should be limited solely to amounts that are effectively connected to the permanent establishment. The mere existence of a permanent establishment should not push all locally sourced income away from withholding taxes.
>
> In addition, concerns exist that many foreign entities with permanent establishments are not properly filing their tax returns while acting as the basis for exemption from withholding taxes.
>
> Lack of proper registration means that certain foreign entities are improperly avoiding South African tax altogether.

The withholding tax on service fees was however not favourably received by industry, with the following reasons provided against its introduction:

- The tax is not in line with international norms and will make South Africa unattractive as an investment or operating location;
- It creates an additional administrative burden for South African taxpayers;
- This tax often creates an incentive for businesses to include gross-up clauses in their contracts – although the tax should be an advance payment for tax on profits, in practice, a withholding tax is inadvertently imposed on turnover at percentages that range from 5% to 20%, which effectively erodes the profit margins made by business. To safeguard their margins, non-resident service providers tend to price-in the effect of this tax, which ultimately increases the cost of doing business for local businesses with a potential ripple effect on the prices of goods and services across the nation. [Source: http://www.pwc.co.za/en/press-room/withhold-tax.html] (accessed on 3 November 2016)

In the 2016 Budget Speech, the Minister of Finance tabled a proposal to withdraw the withholding tax on service fees regime which, at that stage, was due to come into effect on 1 January 2017.[16] The reasons cited by the Ministry of Finance for the proposed withdrawal of this withholding tax were that

[14] Taxation Laws Amendment Act, note 4, p.170.
[15] Explanatory Memorandum., note 3, pp.75-76.
[16] Gordhan, P., 2016. National Budget Review. Available: http://www.treasury.gov.za/documents/national%20budget/2016/review/FullReview.pdf [25 February 2018].

the withholding tax on service fees had introduced unforeseen issues, including uncertainty on the application of domestic tax law and taxing rights under tax treaties.[17]

1.2 Main research objective

This dissertation seeks to demonstrate that the permanent establishment threshold is no longer appropriate for the taxation of service fees and, as a result, contributes towards the erosion of the source state's tax base. Various options for addressing this concern are considered and a recommendation is provided as to the option which is most suitable for South Africa.

1.3 Research objectives

The following specific objectives will guide the study:

- Theoretical foundations and rationale for source-based taxation;
- A brief overview of South Africa's domestic tax law, with a special focus on the taxation of service fees;
- A critical analysis of Article 5 of the OECD and UN MTCs (unless otherwise indicated, the dissertation analyses Article 5 of the 2014 OECD MTC and its supporting Commentary and Article 5 of the 2011 UN MTC and its supporting Commentary); and
- Options for addressing the erosion of South Africa's tax base as a result of service fees.

Limitations:

The dissertation specifically excludes the analysis of the following:

- Dependent agent permanent establishment, as the conclusion of contracts to provide services does not in itself give rise to profits;[18]
- Independent personal services (other than if it relates to 'business profits');
- Dependent personal services;
- Remuneration of directors;
- Entertainers and athletes; and
- Other income.

1.4 Methodology

The research in this dissertation is conducted through a comprehensive review of literature dealing with withholding taxes on services and withholding taxes in general. Specifically, the following material is analyzed: relevant South African domestic legislation and judicial precedent; commentary on the OECD MTC and other OECD Reports; UN MTC and related reports; international tax case law and academic literature.

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[17] Gordhan, P., note 16, p.163.
[18] Schwarz, J., 2013. *Schwarz on tax treaties*. 3rd ed. Wolters Kluwer.

1.5 Importance and benefits of the proposed study

A number of jurisdictions are becoming increasingly aware of the base erosion threat that they face as a result of tax avoidance strategies being implemented by taxpayers. For this reason, a number of jurisdictions are initiating tax policy discussions to assist them in identifying an appropriate tool for addressing this threat.

South Africa is one of the countries that faces the threat to the erosion of its tax base, particularly as a result of outward cross-border service fees. It is therefore important that South Africa performs a proper analysis of this problem in order to understand its origin and to identify an appropriate response for addressing it. This dissertation aims to initiate the aforementioned discussions.

Other than being of benefit to SARS' officials and the Finance Ministry, this study will be valuable to tax practitioners; academia and the international tax scene as a whole.

CHAPTER 2

The Principle of Source-based Taxation

Chapter overview

Introduction

The allocation of tax jurisdiction with respect to income, including capital gains, has traditionally been based on the principles of residence and source.[19] Under a residence basis of taxation (also referred to as a world-wide basis of taxation) the connecting factor between the country and the income is the person who receives the income or to whom it has accrued. Whilst with the source basis of taxation (also referred to as the territorial system), the taxpayer generally does not have a personal connection with the territory from which the income arises. Instead, their connection is economical i.e. there is a source of income arising in a territory.

Well-supported doctrine has demonstrated that the source state should have the primary right to tax. Nevertheless, the residence state has traditionally claimed to have the better rights, and this is also reflected in double taxation treaties.[20] In relation to active business income, such as service income, the source state is generally given the primary right to tax such income. In this regard, source is defined as the existence of a permanent establishment i.e. under the OECD MTC and UN MTC, the existence of a permanent establishment is the minimum connection required for the source-based taxation of active business profits. Article 5 of the OECD MTC defines 'permanent establishment' as 'a fixed place of business through which the business of the enterprise is wholly or partly carried on' (subject to certain exclusions). Under the OECD MTC, a permanent establishment also exists where an agent (other than an independent agent) 'is acting on behalf of an enterprise and has, and habitually exercises, … authority to conclude contracts in the name of the enterprise'. This definition of a permanent establishment is extended by the UN MTC to include, *inter alia*, the provision of services by a non-resident who is at least present in the source state for more than 183 days in any 12-month period rendering services in connection with the same or connected project.

The permanent establishment definition reflects the fact that international business activities carried on by corporations have hitherto involved the use of fixed physical or representative premises in each jurisdiction, generally to effect the delivery of goods to consumers in that jurisdiction.[21] In traditional commerce, the reliance on a physical presence is sensible, and the permanent establishment threshold can therefore be applied with relative coherence and certainty so that business profits are attributed only to the more substantial and long-term presences of a corporation in a jurisdiction, not to more fleeting, temporary or ephemeral presences that do not satisfy the required threshold.[22]

However, globalization and the advent of electronic commerce has changed the way that business is conducted thereby raising questions on the existing tax rules which were formulated centuries ago. McLure argues that, compared to now, it was relatively straightforward to apply the income tax rules for international transactions.[23] A permanent establishment could be defined in a straightforward

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[19] Kemmeren, E.C.C.M., 2006. The source of income in globalizing economies: overview of the issues and a plea for an origin-based approach. *Bulletin for International Taxation*. 60(11):430-452. Available: IBFD [20 January 2018].
[20] Kemmeren, E.C.C.M., note 19, p.430.
[21] Pinto, D., note 1, p.273.
[22] *Ibid.*
[23] McLure, C.E. (Jr.), 2001. Globalization, tax rules and national sovereignty. *Bulletin for International Taxation*. 55(8):328–341. Available: IBFD [20 January 2018].

way, and the existence of a permanent establishment was a bright line test of a source country's jurisdiction to tax business profits.[24] McLure attributes the current tax system to the following factors:

- International trade consisted primarily of tangible products;
- Most international trade occurred between unrelated entities;
- A physical presence was generally required for the conduct of business, including the provision of almost all services; and
- Intangible assets were relatively unimportant.[25]

The world described above was one in which countries could, for the most part, structure their taxes with only domestic considerations in mind; countries could achieve substantial operational independence in taxation and were not much constrained by the fear of losing economic activity or their tax base to other countries with lower tax rates.[26] The world economy differs significantly from the one described above. The differences include:

- A substantial amount of international trade consists of services and intangible products;
- Most international trade occurs between related entities;
- A physical presence may no longer be required for the conduct of business, especially trade in intangibles, digital content and services that can be digitized; and
- Intangible assets are vital to the modern corporation. Often there is no external market for their services.[27]

The changes to the world economy as described above have meant that non-resident businesses can now provide services in a source state with very limited presence therein. Take for an example a consulting firm in Jurisdiction A which is engaged by another business in Jurisdiction B. Due to technological advances, it is possible for the consulting firm to only be present in Jurisdiction B (the source state) for a limited period, say 90 days, and finalise the consultation/engagement from Jurisdiction A. In such cases, it has been argued that the source state is not justified in taxing the service fee earned by the consulting firm from Jurisdiction B.[28] Other than for the obvious reason that the consulting firm is unlikely to have created a permanent establishment (as defined under the OECD MTC and UN MTC) in Jurisdiction B, the other reasons advanced against source state taxation in such a case is that the source state's contribution towards the consulting firm earning such service fee is very limited.[29] In essence, these arguments question the relevance of the source-based taxation principle in instances where the non-resident businesses presence in the source state is limited.

[24] McLure, C.E. (Jr), note 23, p.334.
[25] McLure, C.E. (Jr), note 23, pp.333-334.
[26] McLure, C.E. (Jr), note 23, p.334.
[27] *Ibid.*
[28] The majority members of the UN Committee of Experts held the view that, with the advancements in means of communication and information technology, an enterprise of one Contracting State can provide substantial services to customers in the other Contracting State without being present in that State for any substantial period. However, it is noted that a significant minority of the members of the UN Committee of Experts did not agree with the aforementioned view as they held that there is no nexus to that State that warrants taxation by that State on the payment. UN Committee of Experts on International Cooperation in Tax Matters ('UN Committee of Experts'). *Seventh session*. 2016. Geneva: Taxation of services. Available: http://www.un.org/esa/ffd/wp-content/uploads/2016/10/12STM_CRP1_Services.pdf [9 February 2018].
[29] McLure argued that, in a traditional context, taxation based on the benefit theory suggests that a physical presence is probably needed to establish a tax nexus for source-based taxation. Pinto, D., note 1, p.267.

Against this background, this chapter briefly considers the theoretical foundations and rationale for source-based taxation and argues that this system of taxation is relevant even in instances where the non-resident businesses presence in a source state is limited.

2.1 Theoretical foundations and rationale for source-based taxation

2.1.1 Benefit theory

Cooper attributes the benefit theory to the contract theory of the state.[30] He notes that since the terms of the social contract required the government to perform various tasks (such as protecting life or property) and individuals were obliged to fund those services, the extent that individuals benefited from those contracted services determined their liability to tax.[31] Cooper also observes that the formulation of a coherent principle of tax policy premised upon some benefit requires, at the very least, an identification of that benefit and some way of measuring the extent of the benefit given or received.[32] In this regard, he argues that the creation, maintenance and protection of a society within whose markets individuals can pursue and accumulate income and wealth, is the benefit derived from government and, that benefit manifests itself in the income derived by individuals, thus supporting income as an appropriate measure of the benefit.[33]

Pinto on the other hand, expresses the view that the benefits that may be provided by source countries can be either general or specific.[34] He lists examples of general benefits as education (which relates to the availability and level of labour) and police, fire and defence protection.[35] With respect to specific benefits, he states the following:

> The specific benefits include a conducive and operational legal infrastructure for the proper functioning of business. Allied with this may be specific government policies, such as keeping exchange rates stable and interest rates low, thereby providing economic stability and business and consumer confidence.[36]

Globalisation and electronic commerce has made it relatively easy for services to be rendered in one jurisdiction and consumed in another. For this reason, a number of scholars have questioned whether source countries should be limited to taxing income only of those non-resident businesses that have a permanent establishment in the source country as, they argue, the source state's contribution [and equally the benefits that are received by the non-resident businesses] are limited in instances where those businesses have a limited presence in the source state.[37] Thus, Kemmeren expresses the view

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[30] Cooper, G.S., 1994. The benefit theory of taxation. *Australian Tax Forum*. 11(4):397–510. Available: Heinonline [20 January 2018].
[31] Cooper, G.S., note 30, p.432.
[32] *Ibid.*
[33] Cooper, G.S., note 30, p.493.
[34] Pinto, D., note 1, p.267.
[35] *Ibid.*
[36] *Ibid.*
[37] Schön argues that the problem with the benefit theory is that it is difficult to put into operation when it comes to the international allocation of income. He attributes this problem to two predominant reasons: (i) the traditional framework under which a 'state' is connected to a particular 'territory' where the firm operates and finds its suppliers and customers has eroded over the years, and (ii) even where it is possible to link the income-generating activity to a certain territory and the respective market, there is no reliable proportionality between the size of the income arising from a certain activity and the amount of public goods used to generate this income. Schön, W., 2015. Neutrality and territoriality – competing or converging concepts in European tax law?. *Bulletin for International Taxation*. 69(4/5):271–293. Available: IBFD [20 January 2018].

that, from a theoretical perspective, the requirement of a sufficient economic relationship as a consequence of the direct benefit principle implies that an occasional activity is not significant enough to be considered a sufficient relationship with a state, even though an occasional activity creates an economic relationship with a state.[38]

Pinto however challenges the above argument on two grounds. First, he points out to the view expressed by Skaar which is that, even if a business does not have a physical presence in the source country, the business benefits substantially from its infrastructure and therefore should make a contribution to the source country, consistent with the benefit theory of taxation.[39] He notes Skaar's view that:

> A [permanent establishment] is merely a piece of evidence of economic allegiance, not the reason for source-state taxation, … that requires all enterprises which obtain such benefits from a country to render a corresponding contribution to this society, whether or not they have a [permanent establishment].[40]

The second argument advanced by Pinto is that source countries do provide significant benefits to non-resident businesses operating within their borders even in the absence of a physical presence.[41] He notes that non-resident businesses without a physical presence in the source country nevertheless benefit from that country's legal system inasmuch as they rely on it to enforce payment for transactions, uphold intellectual property rights (e.g. trademarks), and maintain a pro-competitive and conducive business environment.[42]

In the author's view, the arguments advanced by Pinto, *albeit* as a defense of the source-based taxation principle in an electronic commerce context, apply equally in instances where non-resident businesses render services in a source state with very limited presence therein. Thus, the source state is justified in taxing these non-resident businesses.

2.1.2 Equity

Judge Stratford CJ correctly captured another theoretical foundation underlying the principle of source-based taxation when he made the following remarks in *Kerguelen Sealing & Whaling Co., Ltd v CIR*[43]:

> …In others (as in ours) the principle of liability adopted is 'source of income'; again, presumably, the equity of the levy rests on the assumption that a country that produces wealth by reason of its natural resources or the activities of its inhabitants is entitled to a share of that wealth, wherever the recipient of it may live… In my opinion the word source is used to convey the idea I have mentioned, *viz.*: that if the natural resources of the Union of South Africa or the activities of its inhabitants produce the wealth, that wealth must be taxed, and this view accords with the notion of the equity of the tax.

[38] Kemmeren, E.C.C.M., note 19, pp.436-437.
[39] Pinto, D., note 1, pp.267-268.
[40] *Ibid.*
[41] *Ibid.*
[42] *Ibid.*
[43] *Kerguelen Sealing & Whaling Co., Ltd v CIR* 1939 AD 487.

Equity is one of the four principles of an ideal tax system which was outlined by Adam Smith in the Wealth of Nations published in 1776.[44] The term 'equity' essentially refers to the even-handed treatment of taxpayers in a tax system.[45] The equity concept has conventionally two facets.[46] First is that known as horizontal equity, which says that taxpayers under identical economic circumstances should be taxed identically.[47] Second is the concept of vertical equity, which postulates that, those taxpayers, who have better economic circumstances (i.e. higher ability to pay), should contribute more than others to the treasury.[48] However, over the years another distinction of equity has been made, that being the distinction of individual equity (i.e. equity considerations which refer to the position of the individual taxpayer) from inter-nation equity (i.e. equity considerations which refer to the gain and loss of the state of citizenship or residence and the state of source).[49] In regard to the latter, Vogel tributes Peggy Musgrave as being the first to make this distinction.[50]

In the context of international taxation, inter-nation equity is more relevant. Under the principle of inter-nation equity, each country should receive an equitable share of the tax revenue from cross-border transactions.[51] An equitable division of the tax revenue depends on (a) the allocation of the tax base between the source and residence countries, and (b) the tax rate in the source country.[52]

Vogel observed that inter-nation equity tends to strongly favour taxation exclusively by the source state.[53] He attributes this finding to the benefit aspects, noting that:

> usually it is the state of source that has provided most or all of the benefits relevant for production of the income. Without this state's economic opportunities the income normally would not have been generated.[54]

At the same time, however, Vogel accepted that a certain integration of the seller's activities into the source country's economy is necessary before the source country's taxing rights arise.[55] This has traditionally been evidenced by the existence of a permanent establishment or by satisfying the 'trading within' concept in common law countries.[56] As such, it is questionable whether inter-nation equity supports source state taxation in situations where non-resident businesses have a limited presence in the source country as, arguably, these businesses do not derive much benefit from the source state.[57] In this regard, Vogel argued that taxation by the source state must be considered under the principle of inter-nation equity:

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[44] Alley, C. & Bentley, D., 2005. A remodelling of Adam Smith's tax design principles. *Australian Tax Reform*. 20:579-624. Available: Heinonline [25 February 2018].
[45] Memon, N., 2010. Prioritizing principles of a good tax system for small business in informal economies. *Australian Tax Forum*. 25(1):57–94. Available: Heinonline [20 January 2018].
[46] Memon, N., note 45, p.77.
[47] Memon, N., note 45, pp.77-78.
[48] Memon, N., note 45, pp.78.
[49] Pinto, D., note 1, p.269.
[50] Vogel, K., 1988. Worldwide vs. source taxation of income – a review and re-evaluation of arguments (Part III). *Intertax*. 16(11):393–402. Available: Heinonline [9 February 2018].
[51] Pinto, D., note 1, p.270.
[52] *Ibid.*
[53] Vogel, K., note 50, p.398.
[54] *Ibid.*
[55] Pinto, D., note 1, p.270.
[56] *Ibid.*
[57] This argument was rebutted in the preceding section.

> It cannot convincingly be denied that providing a market contributes to the sales income at least to some extent as providing the goods does. There is no valid objection, therefore, against a claim of the sales state to tax part of the sales income.[58]

It is contended that the above line of reasoning applies in instances where the non-resident businesses have limited presence in a source state.

2.1.3 Neutrality

The concept of neutrality is an economic concept that is related to the decision-making of economic actors.[59] A tax as such, or a particular tax provision, can be neutral if it does not exercise any influence on the decision of a person to act in a specific manner.[60]

The principle of neutrality in an international context is normally considered within two dimensions of neutrality: capital-export neutrality (CEN) and capital-import neutrality (CIN).[61] Schön notes that capital-export neutrality requires that – from the position of the investor – the tax burden for domestic and foreign investment is equal and therefore does not distort the decision of whether to invest here or there, whilst capital-import neutrality looks at neutrality from the perspective of the host state of the investment and requires equal treatment of economic activities regardless of whether the investor is located abroad or in that country.[62] Based on these definitions, CEN implies a world-wide system of taxation with foreign tax credit whilst CIN on the other hand implies a source-based system of taxation, or one exempting foreign income.

Pinto notes that considerations of international competitiveness point towards source-based taxation under the principle of CIN.[63] He therefore argues that source-based taxation should be preferred over residence-based taxation.[64] Additionally, he notes that the preference for CEN that has traditionally been evident in the literature has been challenged.[65]

The following observations by Vogel give support to the above argument:

> Whether the distinction between capital export neutrality and capital import neutrality is accepted or rejected…taxation of direct investment in foreign countries is economically efficient only if the investor pays no more tax than is imposed on domestic enterprises in the same country in which the enterprise was established. This is consistent with a source-based taxation if 'source' is defined to be the place where the enterprise – or partial enterprise – established by direct investment is located. It is not consistent with a worldwide taxation of income, even if mitigated by a foreign tax credit.[66]

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[58] Pinto, D., note 1, p.270.
[59] Schön, W., note 37, p.272.
[60] *Ibid.*
[61] Pinto, D., note 1, p.268.
[62] Schön, W., 2009. International tax coordination for a second-best world (Part I). *World Tax Journal*. 1(1):67–114. Available: IBFD [21 January 2018].
[63] Pinto, D., note 1, p.268.
[64] *Ibid.*
[65] *Ibid.*
[66] Vogel, K., 1988. Worldwide vs. source taxation of income – a review and re-evaluation of arguments (Part II). *Intertax*. 16(10):310-320. Available: Heinonline [9 February 2018].

CIN therefore means that all investors in a country (whether foreign or domestic investors) face the same effective tax rate on income from their investments, which is sourced in the country.[67]

Against the preceding analysis, the author argues that sourced-based taxation is justified notwithstanding the non-resident businesses limited presence in a source state as this ensures that both resident businesses and non-resident businesses are subject to the same effective tax rate in respect of income sourced in that state.

2.1.4 Entitlement

Vogel observed that among the legal provisions which govern international income taxation, there seems to be a consistent treatment of domestic source income:

> No country which levies an income tax (and very few do not fall into this category today) forgos taxing domestic source income, irrespective of who has derived it… there is no hesitation or dispute with regard to the principle that domestic source income, as far as it is taxable at all, shall be taxable whether derived by foreigners or by nationals.[68]

Musgrave states that the right of a jurisdiction to tax all income arising within its geographical borders is recognized as a fundamental entitlement:

> This permits a country to share in the gains of foreign-owned factors of production operating within borders; gains which are generated in cooperation with its own factors, whether they be natural resources, an educated/or low-cost work force, or the proximity of a market.[69]

On the basis of the above observations, the author contends that source states are entitled to tax income arising within their geographical borders. The fact that non-resident businesses may have had limited presence in the source state does not justify limiting the source state's right to tax income arising within their geographical borders. Indeed, Musgrave states that:

> the tax revenue so obtained may be thought of as a national return to the leasing of these complimentary factors to non-resident investors or temporary workers, or, such taxation may be thought of in benefit terms, as a *quid pro quo* payment for cost-reducing, profit-enhancing services provided by the host country.[70]

2.1.5 Base erosion principle

The base erosion principle supports source country taxation of income from services derived by non-residents if the payments for the services have the effect of eroding the source country's tax base.[71] In this regard, a payment would be considered as eroding the source country's tax base if it was either deductible by a source-country purchaser or formed part of his cost of goods sold (as this would decrease the gain on the sale of goods).[72]

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[67] Holmes, K., 2007. *International tax policy and double tax treaties: an introduction to principles and application*. IBFD.
[68] Vogel, K., 1988. Worldwide vs. source taxation of income – a review and re-evaluation of arguments (Part I). *Intertax*. 16(8/9):216–241. Available: Heinonline [9 February 2018].
[69] Musgrave, P.B., 2001. Sovereignty, entitlement and cooperation in international taxation. *Brooklyn Journal of International Law*. 26(4):1335–1356. Available: Heinonline [21 January 2018].
[70] Musgrave, P.B., note 69, pp.1341-1342.
[71] Arnold, B.J., 2010. The taxation of income from services under tax treaties: cleaning up the mess (expanded version). *Bulletin for International Taxation*. 65(2):1–29. Available: IBFD [21 January 2018].
[72] Pinto, D., note 1, p.275.

The base erosion principle in effect seeks to offset the reduction of the source country's tax base by the deductible payments against the source country's tax on the corresponding income earned by the non-resident.

Whilst Arnold acknowledges that the base erosion principle could apply more broadly to all deductible payments for services made by residents (and non-residents with a permanent establishment or fixed base) in the source country, he cautions that the broader the application of this principle is, the more likely it is to conflict with the source and threshold principles.[73] He therefore suggests that the base erosion principle be treated as a subsidiary principle that may justify a lower threshold for source country taxation of income from services or special anti-avoidance measures where payments to non-residents for services provided in the source country are deductible against the source country tax base (for example, payments to a related non-resident).[74]

The UN Committee of Experts, on the other hand, supports the base erosion principle and argues that it is a sufficient link to justify source-taxation.[75] In this regard, the UN Committee of Experts points out to the fact that this principle is applied in Article 16 (Directors' fees and remuneration of top-level managerial officials).[76]

The author also notes that this principle has received support from a number of countries who have included the Fees for Technical Services article in their double tax treaties.[77] Such an article is built on the base erosion principle.

Conclusion

The purpose of this chapter was to briefly highlight the arguments which justify the principle of source-based taxation. As can be seen from the arguments presented by the author, the principle of source-based taxation is underpinned by robust theoretical foundations and remains relevant even in instances where the non-resident businesses have a limited presence in the source state.

The author also notes that two of the theories dealt with in this chapter (neutrality and equity) were in fact identified by the OECD as some of the principles which are relevant and should be considered when designing tax policy targeting the digital economy.[78] As the digital economy arguably creates similar issues for the source state as non-resident businesses who operate therein with limited presence, these principles are equally relevant in the case of non-resident businesses with limited presence in the source state.

Other than for the theories discussed in this chapter, which support the principle of source-based taxation, the author notes that a source state is best placed to tax income arising within its

[73] Arnold, B.J., note 71, p.22.
[74] *Ibid.*
[75] UN Committee of Experts, note 28, p.4 of Annex 2.
[76] UN Committee of Experts, note 28, pp.6-7 of Annex 2.
[77] A survey conducted by the IBFD identified 134 of the almost 1,600 tax treaties concluded between 1997 and 2011 as containing a separate article dealing with fees for technical services. Wijnen, W.F.G., de Goede, J.J.P. & Alessi, A., 2012. The treatment of services in tax treaties. *Bulletin for International Taxation*. 66(1):27-38. Available: IBFD [25 February 2018].
[78] OECD. 2015. Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report ('Final Report on Action 1'). OECD Publishing, Paris. Available: http://dx.doi.org/10.1787/9789264241046-en [9 February 2018].

geographical borders. Pinto observes that source countries typically have the first opportunity to tax income derived within their borders and are unlikely to forgo taxing such income.[79] Thus, even if other bases of taxation may be preferred on economic or theoretical grounds, they are unlikely to be followed in practice, especially in the case of business income derived from large markets, where there may be little fear that a non-resident business will abandon the market because of the tax levied by the source jurisdiction.[80] Against this background, the author contends that source-based taxation is not only relevant but is also practical.

In the author's view, any weaknesses in the arguments in support of source-based taxation, especially in instances where the non-resident businesses have a limited presence in the source state, do not justify the limitation of the source state's right to tax income arising within its geographical borders. Such an action would contribute towards the erosion of the source-states' tax base as it would result in income being shifted to the resident states. Thus, the author considers that the base erosion principle prevails against any weaknesses in the arguments in support of source-based taxation. Instead, such weaknesses (if any) should encourage discussions regarding the means in terms of which the source states' taxing rights in respect to service fees may be extended so as to prevent the erosion of its tax base notwithstanding the non-resident businesses' limited presence in the source state.

[79] Pinto, D., note 1, p.272.
[80] *Ibid.*

CHAPTER 3

Overview – Taxation of cross-border service fees in South Africa

Chapter overview

3. Taxation of cross-border service fees in South Africa

3.1 Definition of 'service fees'

3.2 'Source' of service fees

3.3 Double tax treaty analysis

Introduction

The objective of this chapter is to provide an overview of the taxation of cross-border service fees under the South African domestic legislation. The chapter begins by considering the meaning of the term ‘service fees’ within the domestic legislation followed by an analysis of the ‘source’ of services fees and double tax treaty analysis to determine circumstances under which a non-resident would be subject to South African corporate income tax on service fees derived from a South African source.

3.1Taxation of cross-border service fees in South Africa

A non-resident is subject to South African corporate income tax on service fees if the service fees arise from a South African source and such fees are not exempt from South African corporate income tax in terms of an applicable double tax treaty.

Before the ‘source’ of service fees and double tax treaty analysis is conducted, it is appropriate to first consider the meaning of ‘service fees’ in a South African income tax context.

3.1.1 Definition of ‘service fees’

The term ‘service fees’ is not defined in the Income Tax Act nor in common law. It would appear that the legislators have left the task of determining the meaning of this term to taxpayers. Taxpayers would therefore need to apply their minds in determining whether the income they have earned is in fact ‘service fees’.

Under the repealed Withholding Tax on Service Fees regime[81], the term ‘service fees’ was defined in section 51A as ‘*any amount that is received or accrues in respect of technical services, managerial services and consultancy services but does not include services incidental to the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render any assistance or service in connection with the application or utilization of such knowledge or information’*. What is clear in this definition is that any services which fall within the ambit of the Royalties Withholding Tax provisions[82] are specifically excluded from the definition of ‘service fees’. This definition also reflects the legislator’s intention in introducing the withholding tax on service fees, which was to withhold tax on fees which were derived by non-residents from rendering services of a technical, managerial or consultancy nature as opposed to services of a less technical nature.[83] In the author’s view, this definition of service fees i.e. fees of a technical, managerial or consultancy nature, was intended to align our domestic tax provisions with double tax treaties and thereby enable South Africa to withhold tax on these fees. Generally, the

[81] Part IVC of Chapter II of the Income Tax Act, No. 58 of 1962 (as amended) repealed by section 33 of the Taxation Laws Amendment Act, No. 101 of 1990. Taxation Laws Amendment Act, note 7, p.76.
[82] Sections 49A–49G of the Income Tax Act, No. 58 of 1962 (as amended).
[83] Explanatory Memorandum, note 3, p.76.

Technical Fees and Management Fees articles in most double tax treaties define technical fees and management fees as being fees of a technical, managerial or consultancy nature.[84]

With the repeal of the Withholding Tax on Service Fees regime, it was no longer necessary to define the term 'service fees' as the South African domestic legislation does not contain any provisions which specifically target service fees. Rather, any 'service fees' earned by a business are included in its gross income along with its income from its other business activities and subject to corporate income tax at 28%. Further, the absence of a domestic withholding tax on service fees meant that South Africa could no longer subject non-residents to a domestic withholding tax on service fees in terms of, for example, the Technical Fees or Management Fees articles but instead, would generally tax these amounts under the Business Profits article. This shift can be seen with the Reportable Arrangements Notice[85] which replaced the Withholding Tax on Service Fees regime. Under the Reportable Arrangements Notice, the services which are targeted are consultancy, construction, engineering, installation, logistical, managerial, supervisory, technical or training services. The author contends that this widening of the scope of services reflects the shift from the intention to withhold tax on service fees to the current position of taxing the services fees under the Business Profits article. Since the Business Profits article does not differentiate 'ordinary' business activities from services of a technical, consultancy or managerial nature, but rather seeks to tax profits of a business attributable to its permanent establishment situated in a source state, it is argued that there was no longer a need to define 'service fees' in our domestic legislation.

In relation to the services listed in the Reportable Arrangements Notice, the author contends that this list of services is exhaustive. The Reportable Arrangements Notice specifically states:

> An arrangement for the rendering to a person-
>
> (a) ... or
> (b) that is not a resident that has a permanent establishment in the Republic to which that arrangement relates,
>
> **of consultancy, construction, engineering, installation, logistical, managerial, supervisory, technical or training services**, in terms of which...[86]
>
> [author's emphasis in bold]

In the authors view, the absence of the word 'includes' before the list of services, indicates that this list is exhaustive. Thus, where a non-resident earns service fees in connection with the rendering of services other than those mentioned in the Reportable Arrangements Notice, the resident payor arguably has no duty to report. However, on the basis that the Reportable Arrangements Notice is merely intended to assist SARS in identifying and collecting revenue from non-residents who derive service fees from a South African source, the prudent approach would be to report any service that is

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[84] For example, Article 13 of the double tax treaty between South Africa and Malaysia, and Article 20 of the double tax treaty between South Africa and Ghana respectively.

[85] Public Notice Listing Arrangements for Purposes of sections 35(2) and 36(4) of the Tax Administration Act, No. 28 of 2011 ('Reportable Arrangements Notice'). 2016. Government gazette. 608(39650). 3 February. Government notice no. 140. Cape Town: Government Printer. Available: http://www.gpwonline.co.za/Search/Pages/gazetteresults.aspx?k=39650 [9 February 2018].

[86] Reportable Arrangements Notice, note 85, p.7.

rendered by a non-resident which at least meets the R10m threshold (whether or not it falls within the list of services mentioned in the Reportable Arrangements Notice). The support for this approach also stems from the fact that the services listed in the Reportable Arrangements Notice, for example, 'consultancy' or 'technical services' have the potential to be interpreted widely thus increasing the risk that any services provided by a non-resident, otherwise not listed in the Reportable Arrangements Notice, could be construed by the revenue authorities as falling within the 'consultancy' or 'technical services' category. Thus, those services could still be taxed in South Africa, notwithstanding the fact that they are not specifically listed in the Reportable Arrangements Notice, provided that they are from a South African source and are attributable to the non-resident's permanent establishment in South Africa.

In the absence of a definition of 'service fees' in the South African domestic legislation, it is contended that the ordinary meaning of the term should be referenced in determining whether or not the income in question is a service fee. In this regard, the *Concise Oxford English Dictionary*[87] defines a 'service' as, *inter alia*, *the action or process of serving, a period of employment with a company or organization and a system supplying a public need such as transport, or utilities such as electricity and water*. Arnold contends that the more appropriate definition of this term is that found in the *Black Law's Dictionary*, i.e. *the act of doing something useful for a person or company for a fee*.[88] What can be read with certainty from this definition is that a 'service' generally excludes the supply of goods. Thus, any income earned in an act of 'service' should constitute 'service fees'. For tax purposes however, it will be necessary to distinguish, for example, between services rendered by a corporate entity from personal services as different rules apply in terms of the taxpayer's profile.

3.1.2 'Source' of service fees

Section 9 of the Income Tax Act contains a statutory definition of 'source' in respect of certain forms of income.[89] Interestingly, service fees are not dealt with in this section. The following extract from the Explanatory Memorandum explains the reason for this exclusion:

> The source determination for services is based solely on the common law. This source determination largely focuses on the place where the services are rendered (with some minority arguments in favour of the dominant activity giving rise to those services). If services are rendered partly within and partly outside South Africa, the allocation of source is based entirely on the facts and circumstances (e.g. time and value addition). The basic common law source rules for services will remain unchanged.[90]

Thus, in determining the 'source' of services fees, the general principles laid down in *CIR v Lever Brothers and Unilever Ltd* will have to be followed.[91] In terms of this case, the determination of

[87] Concise Oxford English Dictionary. Eleventh Edition, Revised.
[88] Arnold, B.J., note 71, p.1.
[89] Section 9 of the Income Tax Act, No.58 of 1962 (as amended).
[90] Explanatory Memorandum, 2011 (draft). 2011. Available: http://www.treasury.gov.za/legislation/bills/2011/Draft%20Explanatory%20Memorandum%20on%20the%20Taxation%20Laws%20Amendment%20Bill%202011.pdf [9 February 2018].
[91] *CIR v Lever Brothers and Unilever Ltd ('CIR v Lever Bros')*, 1946 AD 441, 14 SATC 1.

source generally involves the doctrine of originating cause involving the following two levels of analysis:

- What is the originating cause of the income; and
- What is the location of that originating cause?

In other words, the first question is to determine what gave rise to the income and only after this has been established can the second question be determined, namely, in which country were the activities which gave rise to the income conducted.[92]

Regarding the first question, Williams is of the view that the originating cause of income from services is the services themselves:

> There is strong authority for the principle that the originating cause of income from services is the service themselves and not, for example, the contract in terms of which they are rendered. This principle underlies the decisions in *CIR v Lever Bros*[93], *Millin v CIR*[94], *CIR v Epstein*[95] and *COT (SR) v Shein*[96]. In terms of this principle it is irrelevant who the payer was or where payment was made.[97]

It therefore follows that the location of the originating cause should be where the services are performed.[98] This was the case in *Millin v CIR* where the taxpayer, (Mrs Millin), wrote books in South Africa and granted to her publishers in England the right of printing and publishing her novels in Great Britain and elsewhere in return for a royalty payment. It was held that the source of the whole of her income was in South Africa. Solomon CJ said:

> It was the exercise of her wits and labour that produced the royalties. They were employed in the Union, and it matters not, on the analogy of the Overseas Trust case, that the grant to her publishers of the right to publish her book was contained in a contract made in England. Her faculties were employed in the Union both in writing the book and in dealing with her publishers, and, therefore, on the test applied in the cases cited, the source of the whole of her income would be in the Union.[99]

Where the 'originating cause' of a particular amount of income is located partly in South Africa and partly in another country, its source may lie partly within South Africa and partly in another country with the result that the entire income, or a portion of it, or none of it is taxable as income from a source in South Africa. This was noted by Watermeyer CJ in *CIR v Lever Bros*:

> Turning now to the problem of locating a source of income, it is obvious that a taxpayer's activities, which are the originating cause of a particular receipt, need not all occur in the same place and may even occur in different countries, and consequently, after the activities which are the source of the particular 'gross income' have been identified, the problem of locating them may present considerable difficulties, and it may be necessary to come to the conclusion that the 'source' of a particular receipt is located partly in one country and partly in another. See the remarks of Lord Atkin in *Rhodesia Metals Ltd (in liquidation) v COT*. Such a state of affairs may lead to the conclusion that the whole of a receipt, or part of it, or none of it

[92] Olivier, L. & Honiball, M., 2011. *International tax: a South African perspective*. Rev. 5th ed. SiberInk.
[93] *CIR v Lever Bros.,* note 91.
[94] *Millin v CIR*, 1928 AD 207, 3 SATC 170.
[95] *Commissioner for Inland Revenue v Epstein*, 1954 (3) SA 689 (A), 19 SATC 221.
[96] *Commissioner of Taxes (SR) v Shein*, 1958 (3) SA 14 (FC), 22 SATC 12.
[97] Williams, R.C., 1995. *Income tax in South Africa: cases and materials*. Butterworth Publishers (Pty) Ltd.
[98] Williams, R.C., note 97, p.34.
[99] *Millin v CIR*, note 94, p.176.

> is taxable as income from a source within the Union, according to the particular circumstances of the case, but I am not aware of any decision which has laid down clearly what would be the governing consideration in such a case.[100]

Williams observes that our Income Tax Act is silent as to whether apportionment is permissible in these circumstances, and if so, on what basis the apportionment is to be accomplished.[101] He further notes that a weight of judicial opinion seems to favour the view that apportionment is, in principle, permissible, but that the practical difficulties in assigning income to different sources may compel the assessment to be based only on the 'dominant or main or substantial or real and basic source of the accrual' and require sources of a lesser importance to be ignored.[102] Indeed, this seems to be the approach that has been adopted by our courts in cases such as *Transvaal Associated Hide and Skin Merchants v Collector of Taxes*[103], *CIR v Black*[104] and *COT (SR) v Shein*[105].

Williams is also of the view that, in relation to service fees, there is authority for the proposition that, where the source of income is services rendered by the taxpayer and those services were rendered mainly in one country but a trivial, incidental and entirely subsidiary part of the services was rendered in a second country (and particularly if no separate payment was made for the latter services), the whole amount will be regarded as having its source in the first-named country.[106] He points out that, it is only where a single amount of income (for example, the selling price of an item of property) has a composite source, being partly from a source in the Republic and partly from a source outside, that the issue of apportionment arises.[107]

In conclusion, the general principles of the 'source' of service fees therefore seem to be that the originating cause of 'service fees' are the services rendered which is the *quid pro quo* in respect of which income is earned and that this originating cause is located where the services are actually rendered. Where the 'service fees' arise as a result of more than one originating cause, the dominant cause should be distinguished from the incidental cause with recognition only been given only to the dominant cause.

3.1.3 Double tax treaty analysis

The term 'tax treaty' is defined in the *International Tax Glossary* as a 'term generally used to denote an agreement between two (or more) countries for the avoidance of double taxation'.[108] Where a treaty is entered into between two parties, it is referred to as a double tax treaty, whilst treaties involving more than two parties are usually referred to as multilateral treaties.

[100] *CIR v Lever Bros*., note 91, p.10.
[101] Williams, R.C., note 97, p.21.
[102] *Ibid.*
[103] *Transvaal Associated Hide and Skin Merchants v Collector of Income Tax, Botswana* (1967) 29 SATC 97 (Court of Appeal, Botswana).
[104] *CIR v Black*, 1957 (3) SA 536 (A), 21 SATC 226.
[105] *Commissioner of Taxes (SR) v Shein*, 1958 (3) SA 14 (FC), 22 SATC 12.
[106] Williams, R.C., note 97, p.22.
[107] *Ibid.*
[108] Holmes, K., note 67, p.54.

As far back as 2002, there were over 2000 treaties in effect.[109] Most of these treaties are based on the OECD MTC and, to a certain extent, on the UN MTC.[110] Holmes also notes that there are other MTCs besides those put forward by the OECD and the UN.[111]In most cases, those other models are the basis on which a country, or a group of countries, formulates its double tax agreements ('DTAs').[112] An example of this is the United States MTC.

As at 6 October 2017, there were 79 double tax treaties which had been entered into by South Africa and which were in force. A review of these double tax treaties shows that the OECD and UN MTCs were the main basis for their formulation.

In South Africa, the provision in the Income Tax Act which enables the application of a double tax treaty entered into by South Africa and the Governments of other states is section 108.[113] In terms of section 108, the National Executive may enter into an agreement with the government of any other country, whereby arrangements are made with such government with a view to*, inter alia*, prevent the levying, under the laws of South Africa and of such other country, of tax in respect of the same income, profits or gains. As soon as an agreement has been approved by Parliament, the arrangements made must be notified by publication in the Gazette where upon such arrangements will have the same effect as if enacted by the Income Tax Act.[114]

Olivier and Honiball hold the view that, where tax is payable in respect of a particular income, profit or gain under South African domestic law, if in terms of the provisions of a double tax treaty the relevant tax is not payable in South Africa (or only part of that tax is payable), then the double tax treaty automatically takes precedence and overrides the relevant domestic law in terms of which the tax is payable.[115] This seems to be the view adopted by the South African courts in cases such as *ITC 1544* 54 SATC 456.[116]

Accordingly, once it is established that a non-resident has earned services fees from a South African source, such service fees will be subject to South African corporate income tax at the rate of 28% unless exempt from South African corporate income tax in terms of an applicable double tax treaty.

The OECD and UN MTCs have a number of articles which deal with items of income and which potentially apply to income from services. In order to establish the appropriate treatment of an item of income under these MTCs, the nature of the income in question needs to be ascertained. Where an item of income is covered by more than one article, the more specific article should be applied first.[117]

In relation to service fees earned by a business, the article in the OECD and UN MTCs which find application to such income is Article 7 (Business Profits). Under Article 7, the profits of an enterprise

[109] *ITC No. 13276*.
[110] Olivier, L. & Honiball, M., note 92, p.268.
[111] Holmes, K., note 67, p.62.
[112] *Ibid.*
[113] Section 108 of the Income Tax Act, No.58 of 1962 (as amended).
[114] *Ibid.*
[115] Olivier, L. & Honiball, M., note 92, p.305.
[116] *Ibid.*
[117] Holmes, K., note 67, pp.93-94.

may only be taxed in the source state if the enterprise carries on business in a source state through a permanent establishment situated therein. The term 'permanent establishment' is in turn defined under Article 5 of both the OECD and UN MTCs as essentially comprising *a fixed place of business through which the business of the enterprise is conducted*. However, the UN MTC expands this definition to include a services permanent establishment which refers to services performed in the source state by an enterprise through its employees who are present in the source state for a period aggregating more than six months within any twelve-month period.[118]

Approximately 42 of the double tax treaties entered into by South Africa as at 6 October 2017 contain the services permanent establishment provision[119], whilst 37 can generally be viewed as containing a variation of the OECD MTC permanent establishment definition.

In the absence of a permanent establishment (i.e. fixed place of business or services permanent establishment), a non-resident business which has earned South African sourced service fees will escape South African corporate income tax on such service fees. However, as the resident payor is generally afforded a deduction of this amount, there is a risk of the erosion of South Africa's tax base.[120] In an effort to address this potential tax base erosion, the Taxation Laws Amendment Act No. 31 of 2013 introduced a withholding tax on service fees.[121] In terms of this regime, a 15% tax would have been withheld on any service fee from a South African source which is paid by a resident to a non-resident. Thus, notwithstanding the absence of a permanent establishment, a non-resident could have still been subjected to tax on service fees derived from a South African source.

However, in the 2016 Budget Speech, the Minister of Finance tabled a proposal to withdraw the withholding tax on service fees which had been due to come into effect on 1 January 2017.[122] The withholding tax on service fees was subsequently repealed by section 60 of the Taxation Laws Amendment Act No. 15 of 2016.[123] One of the reasons cited for the withdrawal of this regime was that it would have generated limited revenue due to limited taxing rights under double tax treaties.[124] This is because, in a treaty context, service fees derived by a business are generally subject to the Business Profits article, unless the double tax treaty in question contains an article such as the Technical Fees article which enables the withholding tax on technical fees.

[118] Article 5 of the OECD MTC does not contain a services permanent establishment. However, the services permanent establishment is provided as an alternative treaty provision in the Commentary to the OECD MTC. Thus, Contracting States can elect to include the services permanent establishment in their double tax treaties if they so prefer. OECD, note 9, pp.239-240.
[119] The time threshold in 6 of these double tax treaties differ from the six months provided in the UN MTC. See Annex A.
[120] Explanatory Memorandum, note 3, p.75.
[121] Taxation Laws Amendment Act, note 4, pp.176-180.
[122] Gordhan, P., note 16, p.163.
[123] Taxation Laws Amendment Act, note 7, p.76.
[124] Explanatory Memorandum, 2016. Available: http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2016-02%20-%20EM%20on%20the%20Taxation%20Laws%20Amendment%20Bill%2017B%20of%202016%2015%20December%202016.pdf [26 February 2018].

Neither the OECD MTC nor the UN MTC currently incorporates an article on technical fees.[125] The first Technical Fees article can be traced back to the 1989 double tax treaty between India and the United States.[126]

Schwarz observes that:

> several treaties with developing countries make an important exception to the permanent establishment principle in the context of fees for technical services... Thus, where technical services are provided, they may be taxed in the country of source, despite the absence of a permanent establishment in the source state where the fee arises rather than at the place of performance of the services. This differentiates such provisions from a service permanent establishment which requires the services to be performed in the source country. These articles are included at the instance of the other contracting states and are commonly aimed at protecting withholding taxes on gross fees paid to non-residents for consulting services where there is no permanent establishment. The rate of tax is usually linked to the rate set with respect to royalties. The article gives primary taxing rights over the fees to the country in which the fees arise, this being deemed to be the country of which the payer is a resident.[127]

As at 6 October 2017, South Africa had only entered into 13 double tax treaties which contained a Technical Fees article.[128] The term 'technical fees' is generally defined in these double tax treaties as payments in consideration for any services of a managerial, technical or consultancy nature. However, the terms 'managerial', 'technical', or 'consultancy', are in themselves not defined.

With the repeal of the Withholding Tax on Service Fees regime in South Africa, the effect is that the Technical Fees and Management Fees articles in its double tax treaties cannot find application in respect of a service fee derived by a non-resident from a South African source. Instead, such service fees will be dealt with under the Business Profits article.

Conclusion

With regards to the taxation of service fees, the critical issues for consideration from a South African perspective include: (i) determining whether the income in question does in actual fact constitute a 'service fee' as opposed to, for instance, sales income, and (ii) determining the 'source' of the service fees. The analysis of the aforementioned factors can be complex depending on the transaction in question, for example, if the transaction is a composite transaction involving the sale of goods and the provision of services it can be difficult to ascertain the services component or if the services are provided in a number of locations it can be difficult to determine the location of the *originating cause*. However, once it is ascertained that a non-resident has earned a 'service fee' from a South African 'source', such service fee will be subject to South African corporate income tax unless it is exempt in terms of an applicable double tax treaty.

[125] The UN Committee of Experts have approved the text of a new Fees for Technical Services Article. It is proposed that this new article be included in the next update of the UN MTC. UN Committee of Experts, note 28, p.2.
[126] Wijnen, W.F.G., de Goede, J.J.P & Alessi, A., note 77, p.32.
[127] Schwarz, J., note 18, pp.236-237.
[128] In three of these double tax treaties, the Technical Fee provision is included in the Royalties article, whilst in one of the double tax treaties, a Management Fee article is included and is defined as payments in consideration for services of a managerial, technical or consultancy nature. See Annex A.

South Africa has an extensive double tax treaty network. These double tax treaties are mainly based on the OECD and UN MTCs. Under these MTCs, the source state's taxing rights in respect of active income derived by a non-resident business from the source state, tends to be limited to instances where the non-resident business has created a permanent establishment in the source state. In the case of the OECD MTC, the permanent establishment threshold will be satisfied where the non-resident business operates in the source state essentially through a fixed place of business. Although the provisions of the OECD MTC and UN MTC are fairly similar, under the UN MTC a non-resident can also satisfy the permanent establishment threshold where it renders services through its employees present in the source state for a period aggregating more than six months in any twelve-month period.

It follows that, in the absence of a permanent establishment, the non-resident will generally not be subject to any corporate income tax in South Africa.

Due to concerns around the potential tax base erosion resulting from outbound cross border service fees, the National Treasury attempted to introduce a withholding tax on service fees. This withholding tax would have had the effect that, where a non-resident derives a 'service fee' (as defined under the withholding tax on service fees provisions) from a South African source, the non-resident would have been subjected to a withholding tax in South Africa at the rate of 15% (or at a lower rate provided by an applicable double tax treaty) on such service fee. However, the Withholding Tax on Service Fees regime was later repealed owing to concerns on the limited revenue it would have generated due to limited taxing rights under double tax treaties.

Thus, the current position in South Africa is that a non-resident will only be subject to corporate income tax on service fees from a South African source, if it has a permanent establishment in South Africa <u>and</u> the service fees are attributable to this permanent establishment.[129]

[129] Unless the service fees are exempt in terms of an applicable double tax treaty.

CHAPTER 4

A critical analysis of the OECD and UN MTCs' permanent establishment definition

Chapter overview

Introduction

In Chapter 3 of this dissertation, it was ascertained that a non-resident who derives South African sourced service fees will be subject to corporate income tax on such service fees unless exempt in terms of an applicable double tax treaty.

An observation was also made that, in terms of the double tax treaties entered into by South Africa, South Africa's right to tax South African sourced service fees derived by a non-resident is generally limited to instances where the service fees are attributable to the non-resident's permanent establishment situated in South Africa. In this regard, the double tax treaties entered into by South Africa are mainly based on the OECD and UN MTCs, which define a permanent establishment as essentially comprising of a fixed place of business as well as, in the case of the UN MTC, a services permanent establishment, that is, the furnishing of services by an enterprise through its employees present in the source state for 183 days or more for the same project, or for a connected project.

This chapter proceeds on the premise that the principle of source-based taxation is justified notwithstanding a non-resident's limited presence in the source state (see chapter 2) and that any limitation on the source state's right to tax income arising within its geographical borders on the basis of limited presence in the source state, will lead to the erosion of the source-state's tax base.

Arnold observes that there are essentially two ways in which the tax base of developing countries can be eroded through the performance of services by non-residents:

> First, if a non-resident service provider does not have any permanent establishment or fixed base in the developing country, any income from services may not be taxable by the developing country under its domestic law or under the provisions of an applicable tax treaty … Second, if the services are provided outside the developing country but are deductible in computing the payer's income for purposes of the developing country's tax, the developing country may be unable to tax the income under its domestic law or under the provisions of an applicable tax treaty.[130]

Against the above comments, the objective of this chapter is to critically analyse the permanent establishment definition as found in the OECD and UN MTCs as applicable to service fees and to demonstrate that the permanent establishment threshold contributes towards the erosion of the source states' tax base.

The chapter begins by providing a brief history of the origin of the OECD and UN MTCs, followed by a critical analysis of the permanent establishment definition. This analysis is performed under the following sub-headings: (i) 'fixed place of business' threshold, (ii) 'days-of-work' threshold, and (iii) artificial avoidance of permanent establishment status.

[130] Arnold, B.J., 2013. The taxation of income from services (draft). *UN' workshop on 'Tax base protection for developing countries'*. 4 June 2014. 1-52. Available: http://www.un.org/esa/ffd/tax/2014TBP/Paper2_Arnold.pdf [9 February 2018].

4.1 A historical overview of the OECD and UN MTCs

4.1.1 Origin of the OECD MTC

The origin of the OECD MTC can be traced back to the early 1920's when the League of Nations appointed four economists to study the issue of double taxation from a theoretical and scientific perspective.[131] The need for this study arose due to concerns around instances of double taxation as global trade increased in the early 20th century.[132]

The group was tasked with, amongst others, determining whether it was possible to formulate general principles as the basis of an international tax framework capable of preventing double taxation, including in relation to business profits.[133] In this regard, the group identified the concept of economic allegiance as a basis to design such international framework.[134] Economic allegiance is based on factors aimed at measuring the existence and extent of the economic relationships between a particular state and the income or person to be taxed.[135] The group identified the following factors as comprising economic allegiance: (i) origin of wealth or income, (ii) *situs* of wealth or income, (iii) enforcement of the rights to wealth or income, and (iv) place of residence or domicile of the person entitled to dispose of the wealth or income.[136] The group concluded that, in general, the greatest weight should be given to 'the origin of the wealth [i.e. source] and the residence or domicile of the owner who consumes the wealth'.[137] In this regard, the origin of wealth was defined for these purposes as all stages involved in the creation of wealth, that is, 'the original physical appearance of the wealth, its subsequent physical adaptations, its transport, its direction and its sale'.[138]

The proper place of taxation for the different types of wealth or income was therefore considered by the group on the basis of the above premise.[139] Notably, business profits were not treated separately, but were instead considered under the specific classes of undertakings covering activities nowadays generally categorised as 'bricks and mortar' businesses, namely 'Mines and Oil Wells', 'Industrial Establishments' or 'Factories', and 'Commercial Establishments'.[140] In respect of the aforementioned classes of activities, the group came to the conclusion that the place where income was produced was 'of preponderant weight' and 'in an ideal division a preponderant share should be assigned to the place of origin'.[141] Simply put, in allocating jurisdiction to tax on business profits, greatest importance was attached to the nexus between business income and the various physical places contributing to the production of income.[142]

[131] OECD, note 78, p.24.
[132] *Ibid.*
[133] OECD, note 78, p.25.
[134] *Ibid.*
[135] *Ibid.*
[136] *Ibid.*
[137] *Ibid.*
[138] *Ibid.*
[139] *Ibid.*
[140] *Ibid.*
[141] *Ibid.*
[142] *Ibid.*

The report of the group later formed the basis of the first draft model DTA which was published in 1928.[143] However, due to the limited scope of this model, the League of Nations established its Fiscal Committee in 1929 to consider further developments of the model.[144] The Fiscal Committee was successful in preparing a draft multilateral DTA on the allocation of income from industrial and commercial enterprises in 1933, revised in 1935; however, that model DTA was never adopted.[145] Various draft model DTAs were subsequently prepared between 1935 and 1963 when the OECD (previously called the Organisation for European Economic Cooperation) prepared its first draft OECD model DTA. The most notable of those draft model DTAs were the Mexico[146] and London[147] draft models.

The OECD currently comprises of only 35 member states.[148] Holmes notes that the majority of these member states are Western states, many of which are major industrial countries, i.e. developed countries or capital exporters.[149] He attributes this finding as the reason why the OECD MTC tends to favour the residence state:

> It is therefore unsurprising that the first draft OECD model DTA, published in 1963, reflects the interests of the OECD membership, allocating taxing rights in favour of the country of a taxpayer's residence, as exemplified in the League of Nation's London draft.[150]

Holmes further notes that where one country, which is a party to a DTA, is a developing country, the DTA based on the OECD model can produce a one-sided result as the model usually requires the source country to give up the tax revenue where double taxation would otherwise occur:

> This results from the fact that where developing countries trade with developed countries, (net) income is usually always flowing from the developing country to the developed country. So, generally, the developing country will be the net loser.[151]

Notwithstanding the criticisms against the OECD MTC, it is still the most commonly used MTC and has formed the basis of a number of double tax treaties between developed states as well as between developed and developing states.[152]

4.1.2 The origin of the UN MTC

In view of increasing international trade and the end of colonialism, the need for tax treaties between developed and developing countries was increasingly felt.[153] However, due to the fact that the OECD was perceived as favouring capital exporting countries as opposed to capital importing countries (which are generally developing countries), the developing countries sort recourse from the United

[143] Holmes, K., note 67, p.56.
[144] *Ibid.*
[145] Holmes, K., note 67, p.57.
[146] The significant feature about this draft was its underlying premise that the primary taxing jurisdiction was to be the state of source of income, a position advantageous to developing countries. Holmes, K., note 67, p.57.
[147] The London draft changed the underlying premise of taxing international transactions back in favour of the state of residence of a taxpayer. Holmes, K., note 67, p. 57.
[148] Source: http://www.oecd.org/about/membersandpartners/ [8 November 2017].
[149] The main exceptions being the Czech Republic, Hungary, Mexico, Poland, the Slovak Republic and Turkey. Holmes, K., note 67, p.58.
[150] Holmes, K., note 67, p.58.
[151] Holmes, K., note 67, p.59.
[152] Olivier, L. & Honiball, M., note 92, p.271.
[153] Kosters, L.F., 2004. The United Nations model tax convention and its recent developments. *Asia-Pacific Tax Bulletin*. 10(1):4-11. Available: IBFD [9 February 2018].

Nations for the development of a model DTA which reflected their interests.[154] This led to the establishment of the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries (later known as the Ad Hoc Group of Experts on International Cooperation in Tax Matters) in 1968.[155] This Ad Hoc Group of Experts was made up of tax officials and other tax experts from 20 developed and developing countries, who were to consider ways and means for facilitating the bilateral tax agreements between developed and developing countries.[156]

The work of the Ad Hoc Group of Experts resulted in the preparation of the United Nations Model Double Tax Convention between Developed and Developing Countries, which was published in 1980 (and which was preceded in 1979 by the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries).[157] Holmes observes that this UN MTC was very similar to the OECD's 1977 MTC and thus, can be considered as a direct descendant of the first Model of bilateral tax treaty drafted in 1928 by the League of Nations.[158] However, the UN MTC granted greater taxing rights (particularly with respect to the taxation of business income and passive investment income) to source states, i.e. the capital importing and developing countries, as opposed to the OECD MTC.[159]

On the issue of similarities between the UN MTC and the OECD MTC, the UN states that these reflect the importance of achieving consistency where possible.[160] This can also be seen in the fact that the UN MTC was accompanied by a commentary which, where appropriate, reproduced the 1977 OECD MTC commentary.[161] Holmes notes:

> The OECD commentary was used in order to take advantage of the accumulated technical expertise embodied in that work, but also in acknowledging the widespread use of that model by the OECD member countries, not only amongst themselves, but also with non-member countries including some developing countries.[162]

The UN states that the important areas of divergence exemplify, and allow a close focus upon some key differences in approach or emphasis as exemplified in country practice.[163] The main difference relates to the issue of how far one country or the other should forego, under a bilateral tax treaty, taxing rights which would be available to it under domestic law, with a view to avoiding double taxation and encouraging investment.[164] In this regard, the UN MTC generally favours retention of greater so called 'source country' taxing rights under a tax treaty – the taxation rights of the host country of investment – as compared to those of the 'residence country' of the investor.[165] This has long been regarded as an issue of special significance to developing countries, although it is a position that some developed countries also seek in their bilateral treaties.[166]

[154] Holmes, K., note 67, p.59.
[155] Holmes, K., note 67, p.60.
[156] *Ibid.*
[157] UN, note 10, pp.vii-viii.
[158] Holmes, K., note 67, p.60.
[159] *Ibid.*
[160] UN, note 10, p.vi.
[161] Holmes, K., note 67, p.60.
[162] *Ibid.*
[163] UN, note 10, p.vi.
[164] *Ibid.*
[165] *Ibid.*
[166] *Ibid.*

Although the UN MTC has been applauded for extending the source state's taxing rights, this chapter will demonstrate that, in relation to service fees, the permanent establishment thresholds in both the UN and OECD MTCs have the effect of limiting the source state's taxing rights. This is particularly so in light of globalisation and the advent of electronic commerce.

4.2 A critical analysis of the OECD and UN MTCs' permanent establishment definition

4.2.1 'Fixed place of business' threshold

Article 5(1) of the OECD and UN MTCs define a permanent establishment as a 'fixed place of business through which the business of an enterprise is wholly or partly carried on'. Article 5(2) 'singles out several examples of what can be regarded, *prima facie*, as being permanent establishments', namely:

(a) A place of management;
(b) A branch;
(c) A factory;
(d) A workshop;
(e) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Article 5(3) of the OECD MTC includes as a permanent establishment, a building site or construction or installation project if it lasts more than twelve months, whilst Article 5(3)(a) of the UN MTC expands this list to include an assembly project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months.

Under both the OECD and UN MTCs, there is an exclusion from permanent establishment status if the activities are considered to be preparatory or auxiliary in nature.

With regards to Article 5(1), the Commentary to the OECD MTC states that the definition contains the following conditions:

- A 'place of business', that is, a facility such as premises or, in certain instances, machinery or equipment;
- Which is fixed, that is, a specific geographical spot has to exist and there must be a certain degree of permanence; and
- The business of the enterprise is carried on through this fixed place of business, that is, the 'business connection test'.[167]

The author observes that most of the examples provided under Article 5(2), namely, a branch, factory, workshop etc. serve to re-inforce the idea that only physical facilities can constitute a permanent establishment. The author contends that this premise is no longer valid as in the modern economy certain business models, made possible by globalisation and electronic commerce, have rendered a fixed place of business unnecessary.

[167] OECD, note 9, p.209.

Arnold supports this view and contends that the 'fixed place of business' threshold that applies to the source country taxation of business profits is insufficient for service fees:

> That threshold was adopted at a time when most cross-border business activity involved the manufacture or production and sale of goods. In a modern economy, cross-border services are much more important. Such services can often be performed without the need for any fixed place of business and the country in which services are performed should have the right to tax the income from those services in certain circumstances where there is no PE in the country.[168]

Wichmann states that two main developments in the provision of services should be noted: (i) mobility, and (ii) virtuality:

> "Mobility" characterizes the provision of "tangible" services (e.g. repairs, painting, construction works, on-site consultation) through personnel physically present in the source country, but working from cars, hotel rooms, etc., without establishing a fixed place of business of the enterprise and with only a limited temporary presence in any place where the services are performed, not sufficient to meet the duration requirement of the permanent establishment definition. "Virtuality" characterizes the provision of "intangible" services (e.g. information, advice, remote consultation) through data networks (i.e. the Internet or Intranets) without the service provider having any physical presence in the source country.[169]

A simple example formulated by the author to demonstrate the 'mobility' factor is that of a company (Company X), resident in Jurisdiction Y, which offers mobile spa services and deploys its employees to Jurisdiction Z to render these services. As the employees will not have a 'fixed' place of business at any given time, as they will be rendering services at client premises and possibly in different cities, Company X is unlikely to create a permanent establishment in Jurisdiction Z. This is notwithstanding the fact that the employees could be in the source states for long periods rendering services.

The Commentary to the OECD MTC states the following:

> Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time. It is sometimes difficult to determine whether this is the case.[170]

Arnold notes that the time element, i.e. the *degree of permanence*, implied by the above paragraph creates uncertainty and serious difficulties under double tax treaties.[171] He observes that the OECD Commentary on Article 5 of its MTC does not provide any firm rules for interpreting the time element but merely states what the general practices of OECD Member countries have been.[172] In this regard, he recommends that, in order to reduce the uncertainty concerning the time element, serious consideration should be given to the adoption of clearer rules in either the OECD MTC itself or in its Commentary.[173] He further suggests that the time requirement should not apply to each place of

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[168] Arnold, B.J., note 71, p.11.
[169] Wichmann, M., 2004. The taxation of services: is the permanent establishment the appropriate threshold?. *Bulletin for International Taxation*. 58(5):201-204. Available: IBFD [10 February 2018].
[170] OECD, note 9, p.213.
[171] Arnold, B.J., 2003. Threshold requirements for taxing business profits under tax treaties. *Bulletin for International Taxation*. 57(10):476-492. Available: IBFD [10 February 2018].
[172] Arnold, B.J., note 171, p.484.
[173] *Ibid.*

business in a country, but to all such places in the country.[174] Thus, in his view, the following sentence should perhaps be included in the Commentary to the OECD MTC:

> A fixed place of business shall not constitute a permanent establishment situated in a Contracting State unless the enterprise carries on business through one or more fixed places of business in the same Contracting State for more than six months in any 12-month period.[175]

In the author's view, the 'fixed place of business' threshold is very narrow and does not adequately address all types of services. Whilst this threshold will capture certain services which are still provided in a traditional manner (i.e. through a fixed place of business), it will continue to exclude services which are provided remotely or which are provided with very limited presence in the source state. Although it is accepted that the services permanent establishment is intended to address this issue, the author submits that this solution is also inadequate as the services permanent establishment threshold is high. The services permanent establishment is dealt with below.

4.2.2 'Days-of-work' threshold

The definition of a permanent establishment under the UN MTC contains the so-called 'services permanent establishment', which essentially refers to the furnishing of services by a taxpayer in the source state. The Commentary to the UN MTC states that the inclusion of a services permanent establishment arose from the fact that a number of developing countries felt that management and consultancy services should be covered because the provision of those services in developing countries by enterprises of industrialized countries can generate large profits.

The specific requirements of the services permanent establishment are contained in Article 5(3)(b) of the UN MTC.[176] In terms of Article 5(3)(b) a permanent establishment includes:

> The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.[177]

The OECD has been reluctant to include a similar provision in its MTC. In this regard, the OECD expresses the view that the provision of services should, as a general rule subject to a few exceptions for some types of services (e.g. those covered by Articles 8 and 17), be treated the same way as other business activities and, therefore, the same permanent establishment threshold of taxation should apply to all business activities, including the provision of independent services.[178] The OECD argues that the extension of the cases where source taxation of profits from services performed in the

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[174] *Ibid.*
[175] *Ibid.*
[176] UN, note 10, p.10.
[177] *Ibid.*
[178] OECD, note 9, p.236.

territory of a Contracting State by an enterprise of the other Contracting State would be allowed would increase the compliance and administrative burden of enterprises and tax administrations:

> … This would be especially problematic with respect to services provided to non-business consumers, which would not need to be disclosed to the source country's tax administration for purposes of claiming a business expense deduction. Since the rules that have typically been designed for that purpose are based on the amount of time spent in a State, both tax administrations and enterprises would need to take account of the time spent in a country by personnel of service enterprises and these enterprises would face the risk of having a permanent establishment in unexpected circumstances in cases where they would be unable to determine in advance how long personnel would be present in a particular country (e.g. in situations where that presence would be extended because of unforeseen difficulties or at the request of a client). These cases create particular compliance difficulties as they require an enterprise to retroactively comply with a number of administrative requirements associated with a permanent establishment…[179]

The OECD also points out to difficulties associated with the determination of profits to be taxed and the collection of the relevant tax where the service enterprise does not have a fixed place of business in the source state.[180]

However, in light of the need expressed by certain states to preserve source taxation rights, in certain circumstances, with respect to the profits from such services, the OECD included the alternative services permanent establishment provision in its Commentary.[181]

The alternative provision contained in the OECD MTC Commentary states that where an enterprise of a Contracting State performs services in the other Contracting State:

a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period; or periods are derived from the services performed in that other State through that individual, or
b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State,

the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.[182]

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[179] *Ibid.*
[180] OECD, note 9, p.237.
[181] OECD, note 9, p.239.
[182] OECD, note 9, pp.239-240.

In contrast to the UN MTC's services permanent establishment which only looks at the duration of the activities of the individuals through whom the services are performed, the OECD's permanent establishment alternative provision (subparagraph (a)) also considers the duration of the presence of the individual through whom an enterprise derives most of its revenues. The Commentary to the OECD MTC states that subparagraph (a) deals primarily with the situation of an enterprise carried on by a single individual.[183] It also covers, however, the case of an enterprise which, during the relevant period or periods, derives most of its revenues from services provided by one individual.[184] Such extension is necessary to avoid a different treatment between, for example, a case where services are provided by an individual and a case where similar services are provided by a company all the shares of which are owned by the only employee of that company.[185]

Both subparagraphs (b) of the OECD alternative provision as well Article 5(3)(b) of the UN MTC require that during the relevant periods, the enterprise is performing services through individuals who are performing such services in that other State. For that purpose, a period during which individuals are performing services means a period during which the services are actually provided, which would normally correspond to the working days of these individuals.[186]

The author contends that the days-of-work threshold is excessively high with no reasonable basis to justify it. Assuming a five-day work week, 183 days of work represent approximately 255 days of presence. In a case where, for instance, a non-resident business is engaged on a major project to provide consultancy services and its employees are only physically present in the source state intermittently, say for 60 days in a twelve month period, the non-resident business will not meet the days-of-work threshold and will therefore escape tax in the source state. This would be the case despite the fact that the non-resident business derives a huge profit from the source state from rendering the consultancy services. Regrettably, in connection with the services permanent establishment, neither the Commentary to the UN MTC nor the Commentary to the OECD MTC provide any substantial basis for the 183 days-of-work threshold.

The Commentary to the UN MTC states that a few developing countries oppose the six-month (or 183 days) thresholds in subparagraphs *(a)* and *(b)* of paragraph 3 altogether.[187] The reasons presented by the developing countries for opposing the days-of-work threshold, includes, *inter alia*, the fact that the developing countries believe that the period during which foreign personnel remain in the source country is irrelevant to their right to tax the income (as is the case of artistes and sportspersons under Article 17) and that the threshold could be used by foreign enterprises to set up artificial arrangements to avoid taxation in their territory.[188] In this regard, the Commentary to the UN MTC justifies the threshold as being necessary in effecting the objective of bilateral treaties (which is to promote international trade, investment and development) and therefore, that the threshold encourages businesses to undertake preparatory or ancillary operations in another country that will facilitate a

[183] OECD, note 9, p.243.
[184] *Ibid.*
[185] *Ibid.*
[186] OECD, note 9, p.246.
[187] UN, note 10, p.108.
[188] *Ibid.*

more permanent and substantial commitment later on.[189] The Commentary to the UN MTC then proceeds by referring to the Commentary to the OECD MTC for the basis of the 183 days threshold.[190] Notably, that Commentary to the OECD MTC referred to only relates to Article 5(3)(a) of the OECD MTC, and not the services permanent establishment provisions.

The Commentary to the OECD MTC also does not explain the rationale behind the 183 days-of-work threshold as embodied in subparagraph (b) of its alternative provision, which is an identical provision to Article 5(3)(b) of the UN MTC. It only explains the days-of-presence requirement contained in subparagraph (a) of the alternative provision and states that the formulation of this requirement is identical to that of Article 15(2)(a) and thus, that the principles applicable to the computation of the days-of-presence for purposes of the latter are also applicable to the computation of the days-of-presence for the purpose of the alternative provision.[191]

Arnold is of the view that the days-of-work threshold as embodied in the UN and OECD MTC's is appropriate to the taxation of business enterprises.[192] He notes that the days-of-work threshold is more closely related to the earning of income and provides a better justification for source country taxation.[193] However, he questions whether the 183 days of work threshold is appropriate or should be reduced.[194] According to Arnold:

> There is no compelling reason to reduce the threshold for source country taxation of services to less than 183 days. By the same token, there is no compelling reason not to reduce that threshold to 90 or 120 working days. While it is a matter of judgement … if a resident of one country spends 90 days working in another country, the resident is participating sufficiently in the economic life of that other country to justify that country exercising its jurisdiction to tax the income derived from the services performed in its territory.[195]

Arnold also questions whether or not the same time threshold is appropriate for all tax treaties, irrespective of the particular situation of the contracting states.[196] To the extent that the 183 days threshold is left unchanged, he suggests that the Commentaries to the OECD and UN MTC's be revised to allow countries to agree to a lower threshold in their bilateral tax treaties in appropriate circumstances.[197] As an example, he states that with regard to tax treaties between countries with a reciprocal flow of cross-border services, a higher threshold may be more appropriate than for tax treaties between countries with a disproportionate flow as typically, the flow of cross-border services will be disproportionate between developed and developing countries.[198]

According to the Commentary to the OECD MTC on Article 7:

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[189] *Ibid.*
[190] *Ibid.*
[191] Article 15 deals with Income from Employment. Paragraph 2(a) states that, notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned. OECD, note 9, p.243.
[192] Arnold, B.J., note 71, p.11.
[193] *Ibid.*
[194] *Ibid.*
[195] *Ibid.*
[196] Arnold, B.J., note 71, p.12.
[197] *Ibid.*
[198] *Ibid.*

> …as a general rule, until an enterprise of one State has a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits.[199]

In the author's view, where a non-resident derives significant profits from the rendering of services in the source state, the non-resident should be regarded as participating in the economic life of the source state notwithstanding the fact that the non-resident's presence in the source state may be limited. Certain countries take cognisance of this fact and have lowered the threshold for a services permanent establishment in their bilateral treaties to 90-days within a twelve-month period.[200] However, the author contends that even this lowered threshold is still high taking into account the sophisticated manner in which services are provided in this modern age.

This point can be illustrated through an example of a company (Company X), which is resident in Jurisdiction Y, and which sends its employees to Jurisdiction Z to provide consultancy services for a company resident in Jurisdiction Z. Company X's employees are present in Jurisdiction Z for a period of 30 working-days spread over six months. During the period present in Jurisdiction Z, Company X's employees work at different locations and thus their presence in Jurisdiction Z cannot be pointed to any distinct place with a degree of permanence. Additionally, certain aspects of the project are completed in Company X's country of residence. Company X derives a profit of R100 million from the project.

Under the UN MTC's services permanent establishment definition as well as the OECD's alternative provision, Company X will not be found to have created a permanent establishment in Jurisdiction Z. Thus, Company X will not be regarded as participating in the economic life of Jurisdiction Z sufficiently for it to be subjected to tax in Jurisdiction Z on the profits so derived. In the author's view, this result shows that the days-of-work threshold found in the UN MTC and the OECD's alternative provision is high and fails to take into account the effects of globalisation and the advent of electronic commerce with regards to the provision of services.

Another issue with the services permanent establishment in the UN MTC and OECD alternative provision, which in the author's view, supports the argument that the days-of-work threshold is inappropriately high, is the requirement that the non-resident performs services in the source country for 183 days or more for the same project, or for connected projects. The Commentary to the UN MTC states that:

> The words "for the same or a connected project" are included because it is not appropriate to add together unrelated projects in view of the uncertainty which that step involves and the undesirable distinction it creates between an enterprise with, for example, one project of 95 days' duration and another enterprise with two unrelated projects, each of 95 days' duration, one following the other.[201]

The Commentary to the OECD MTC, on the other hand, provides the following explanation 'for the same or connected projects' requirement:

[199] OECD, note 9, p.302.
[200] See for example South Africa's double tax treaties with Lesotho; Swaziland and Oman.
[201] UN, note 10, p.110.

> The reference to an "enterprise … performing these services for the same project" should be interpreted from the perspective of the enterprise that provides the services. Thus, an enterprise may have two different projects to provide services to a single customer (e.g. to provide tax advice and to provide training in an area unrelated to tax) and whilst these may be related to a single project of the customer, one should not consider that the services are performed for the same project.[202]

It continues to say:

> The reference to 'connected projects' is intended to cover cases where the services are provided in the context of separate projects carried on by an enterprise but these projects have a commercial coherence … The determination of whether projects are connected will depend on the facts and circumstances of each case but factors that would generally be relevant for that purpose include:
>
> - whether the projects are covered by a single master contract;
> - where the projects are covered by different contracts, whether these different contracts were concluded with the same person or with related persons and whether the conclusion of the additional contracts would reasonably have been expected when concluding the first contract;
> - whether the nature of the work involved under the different projects is the same;
> - whether the same individuals are performing the services under projects.[203]

In the author's view, 'the same project or connected projects' requirement contributes towards making the services permanent establishment threshold high. If the intention is that a non-resident be subjected to tax in the source state if it is found to be participating significantly in the economic life of the source state, then the days-of-work threshold should not be viewed on a project-by-project basis. The author does not see any reasonable justification of why a non-resident who may be present in the source state rendering services on multiple projects and deriving significant profits from the source state, should not be subjected to tax in the source state merely because those projects were, individually, undertaken for a period of less than 183 days in a twelve-month period.

Arnold argues that the 'same project or connected projects' requirement imposes an unjustified limitation on source country taxing rights and that it should be eliminated.[204] He states:

> If a non-resident provides services in a country for more than 183 working days, the non-resident's involvement in the commercial life of that country would clearly justify the country taxing the income from those services. The addition of the "same or connected project" condition appears to be an arbitrary requirement designed to restrict source country taxation, because the degree of involvement in the source country's economy is the same, regardless of the number of projects involved. It might be argued that taxpayers can more easily monitor the location of the activities of their employees and independent contractors on a project-by-project basis. This argument is not persuasive. Requiring enterprises, even large enterprises with multiple projects, to keep records with regard to the countries in which their employees and independent contractors are working does not appear to be unduly onerous or unreasonable. Second, the connected-project requirement necessitates difficult factual determinations by the tax authorities.[205]

[202] OECD, note 9, p.245.
[203] OECD, note 9, pp.245-246.
[204] Arnold, B.J., note 71, p.12.
[205] *Ibid.*

Báez Moreno alludes to the difficulties that is caused by this requirement.[206] He points out that 'the same or connected projects' requirement seems confusing and might potentially give rise to endless disputes between the taxpayer and the tax authorities of developing countries.[207] He also observes that this requirement has been removed by certain countries in their bilateral treaties.[208] In this regard, he mentions that out of the 56 treaties of the Czech Republic that contain a service permanent establishment, only 8 include a reference to the same or connected project requirement. New Zealand and India are also mentioned as having removed this requirement in some of their bilateral treaties.[209] The author notes that out of the 42 double tax treaties entered into by South Africa which contain the services permanent establishment provision, only four do not contain 'the same or connected projects' requirement.[210] In the author's view, the inclusion of this requirement reduces the effectiveness of the services permanent establishment provision and is contrary to its purpose, which is to extend source state taxation with respect to profits from services.

Viewed in the context of globalisation and e-commerce, the 183 days-of-work threshold in the UN MTC's services permanent establishment and in the OECD's alternative provision, is excessively high. In the author's view, 'the same or connected projects' requirement only serves to make this threshold even more unattainable and thus prevent source states from rightfully taxing service fees derived from their territory.

4.2.3 Artificial avoidance of permanent establishment status

A scrutiny of the Commentary of either the UN MTC or OECD MTC reveals that the permanent establishment threshold is susceptible to abuse by taxpayers. This can be seen in the various modifications that have been done on the permanent establishment article over the years in an effort to counter its abuse by taxpayers. For instance, the Commentary to the 2003 OECD MTC included comments intended to clarify certain aspects of the phrase 'at the disposal of the enterprise'.[211] Prior to the inclusion of these comments in the Commentary, a view was held that the aforementioned phrase meant that the enterprise needed to have a certain legal right to use the place as a basis for the carrying on of its business activities.[212] Thus, an enterprise which had not entered into a contractual agreement in respect of a space it used to conduct its business could avoid the status of a permanent establishment as it did not have a place of business *at its disposal*. Consequently, the Commentary to the 2003 OECD MTC was updated with comments and examples clarifying the fact that an enterprise which 'has a certain amount of space at its disposal' which is used for business activities is sufficient to constitute a place of business so that no formal legal right is required.[213]

[206] Báez Moreno, A., 2015. The taxation of technical services under the United Nations Model Double Taxation Convention: a rushed – yet appropriate – proposal for (developing) countries?. *World Tax Journal*. 7(3): 1-44. Available: IBFD [20 February 2018].
[207] Báez Moreno, A., note 206, p.10.
[208] *Ibid.*
[209] *Ibid.*
[210] Namely the double tax treaties with Chile, Czech Republic, Greece and Kuwait. See Annex A.
[211] OECD. 2003. Model Tax Convention on Income and on Capital (condensed version). OECD Publishing, Paris. Available: http://dx.doi.org/10.1787/mtc_cond-2003-en [27 February 2018].
[212] OECD. 2003. 2002 reports related to the OECD Model Tax Convention. OECD Publishing. Paris. Available: http://dx.doi.org/10.1787/9789264099920-en [21 February 2018].
[213] OECD, note 211, p.86.

Another mischief noted in the Commentary to the OECD MTC is that relating to the splitting-up of contracts by contractors in an effort to circumvent the time thresholds. The Commentary to the OECD MTC specifically states that:

> ... The twelve month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group.[214]

The Commentary to the OECD MTC further acknowledges that the 183-day threshold provided in its alternative provision may also give rise to the same type of abuse as is described in paragraph 18 above.[215]

To counter these type of abuses, the Commentary to the OECD MTC recommends that domestic anti-avoidance rules should be invoked or solutions adopted in the framework of bilateral negotiations.[216] With respect to the abuse of the alternative provision, the Commentary to the OECD MTC suggests that Contracting States may include in their bilateral treaties a specific provision drafted along the following lines:

> For purposes of paragraph [x], where an enterprise of a Contracting State that is performing services in the other Contracting State is, during a period of time, associated with another enterprise that performs substantially similar services in that other State for the same project or for connected projects through one or more individuals who, during that period, are present and performing such services in that State, the first-mentioned enterprise shall be deemed, during that period of time, to be performing services in the other State for that same project or for connected projects through these individuals. For the purpose of the preceding sentence, an enterprise shall be associated with another enterprise if one is controlled directly or indirectly by the other, or both are controlled directly or indirectly by the same persons, regardless of whether or not these persons are residents of one of the Contracting States.[217]

In the author's view, it is arguable whether the above proposed provision would be successful in reducing the artificial avoidance of the permanent establishment status through the splitting-up of service contracts by non-residents. This is as the success of this provision is dependent on the local authorities' capacity in terms of administrative resources and expertise necessary for detecting such tax avoidance practices. Thus, in the South African context, where an engagement for services is, for example, split into two separate service contracts to be fulfilled by two non-resident subsidiaries of the same group, SARS is likely to only detect this anti-avoidance arrangement if the service fees under each individual contract exceeds the R10 million threshold provided for in the Reportable Arrangements Notice.

Notably, the UN has not recommended a similar anti-avoidance provision in its MTC. Thus, it is not surprising that this provision is not contained in any of the double tax treaties entered into by South Africa. In the absence of this recommended provision in South Africa's double tax treaties, South Africa remains exposed to such avoidance practices and will have to resort to its general anti-

[214] OECD, note 9, p.219.
[215] OECD, note 9, p.247.
[216] OECD, note 9, p.219.
[217] OECD, note 9, pp.247-248.

avoidance rules ("GAAR") or, in the future, the principal purpose test ("PPT") in countering its prevalence.

Oguttu observes that the issue of permanent establishments is one of the most concerning for developing countries, such as those in Africa, whose tax base could be eroded if foreign investors avoid the status of a permanent establishment.[218] She notes that the content of the definition of a permanent establishment is of crucial importance to developing countries if they are to counter its abuse.[219]

The OECD has noted the concerns relating to the avoidance of the permanent establishment status by multinational entities and, as a result, included in its Action Plan on Base Erosion and Profit Shifting ("BEPS") an action (Action 7) specifically aimed at addressing common tax avoidance strategies that are currently used to circumvent the existing permanent establishment definition.[220] Specifically, Action 7 is designed to prevent (i) the artificial avoidance of permanent establishment status through *commissionaire arrangements* and similar strategies; (ii) artificial avoidance of permanent establishment status through the specific activity exemptions, including fragmentation of activities between closely related parties; (iii) other strategies for the artificial avoidance of permanent establishment status such as splitting-up of contracts and strategies for selling insurance in a State without having a permanent establishment therein; and (v) profit attribution to permanent establishments and interaction with action points on transfer pricing.[221]

In relation to the provision of services, the items of Action 7 that are of some relevance are the fragmentation of activities between closely related parties, splitting-up of contracts and profit attribution to permanent establishments. In this regard, the following recommendations have been provided by the OECD:

- Fragmentation of activities between closely related parties: the OECD has proposed a modification to its Commentary such that the current paragraph 27.1 of its Commentary is not restricted to cases where the same enterprise maintains different places of business in a country but is extended to cases where these places of business belong to closely related parties.[222]
- Splitting-up of contracts: the OECD states that the PPT rule which will be added to the OECD MTC as a result of the adoption of the Report on Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances) will address the BEPS concerns related to the abusive splitting-up of contracts.[223]
- Profit attribution to permanent establishments: the OECD concluded that the changes to Article 5 of the OECD MTC as a result of Action 7 do not require substantive modifications to

[218] Oguttu, A.W., 2016. OECD's action plan on tax base erosion and profit shifting: part 2 – a critique of some priority OECD actions from an African perspective – addressing excessive interest deductions, treaty abuse and the avoidance of the status of a permanent establishment. *Bulletin for International Taxation*. 70(6): 329-354. Available: IBFD [21 February 2018].
[219] Oguttu, A.W., note 218, p.344.
[220] OECD. 2015. Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report. OECD Publishing, Paris. Available: http://dx.doi.org/10.1787/9789264241220-en [21 February 2018].
[221] OECD, note 220, p.7.
[222] OECD, note 220, p.41.
[223] OECD, note 220, p.44.

> the existing rules, but that there was a need for additional guidance on the issue of attribution of profits to permanent establishments so as to provide greater certainty about the determination of profits to be attributed to the permanent establishments that result from the changes brought about by Action 7.[224] As of 22 June 2017, the OECD had published a Public Discussion Draft 'BEPS Action 7 – Additional Guidance on Attribution of Profits to Permanent Establishments', which deals with work in relation to Action 7.[225]

The author notes that, in its provisional list of expected reservations and notifications, South Africa has elected for Part IV of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS ("the MLI") to not apply to any of its double tax treaties.[226] Part IV deals with BEPS measures contained in Action 7. This implies that the proposals of Action 7, such as the rules dealing with fragmentation of activities and splitting-up of contracts, will not find application to double tax treaties entered into by South Africa.

It is not clear why South Africa has chosen for the Action 7 measures to not apply to its double tax treaties. Nonetheless, South Africa may still attack such schemes under either GAAR or in terms of Action 6, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, which has been incorporated as Articles 6 and 7 of the MLI.

Conclusion

A number of the existing double tax treaties have been concluded on a basis of either the OECD MTC or the UN MTC, which are both descendants of the first model tax convention drafted in 1928 by the League of Nations. It follows that some of the principles which were fundamental in drafting the first model tax convention may no longer be relevant as the structures and operational procedures of multinational enterprises have significantly changed. Specifically, in relation to business profits, the first model tax convention placed a great emphasis on the nexus between business income and the various physical places contributing to the production of income. This principle has filtered through to the OECD and UN MTCs as evidenced by the requirement contained in these MTCs that business profits derived in a Contracting State should only be taxed in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. In this regard, a permanent establishment is defined by these MTCs as mainly comprising of a 'fixed place of business'.

Globalisation and the advent of electronic commerce has made it possible for businesses to operate in a source country without the presence of a fixed place of business. This is particularly so with the provision of services. Wichmann notes:

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[224] OECD, note 220, p.47.
[225] OECD. 2017. Public Discussion Draft – BEPS action 7 – Additional Guidance on Attribution of Profits to Permanent Establishments. OECD Publishing, Paris. Available: http://www.oecd.org/tax/transfer-pricing/beps-discussion-draft-additional-guidance-attribution-of-profits-to-permanent-establishments.pdf [21 February 2018].
[226] OECD. 2018. Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. OECD Publishing, Paris. Available: http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf [21 February 2018].

> Due to technological progress in communications and infrastructure, the capacity to provide services across the border without using a fixed place of business in the source country has improved notably. The resulting increase in direct cross-border business activities without creating a direct tax liability in the source country raises the question whether the permanent establishment is still the appropriate threshold for taxation in the source country, resulting in an adequate distribution of taxing rights between the residence country and the source country.[227]

The UN seem to acknowledge the fact that the 'fixed place of business' threshold may no longer be appropriate when it comes to the provision of services. This can be seen by the introduction of the services permanent establishment in its MTC. Although the OECD acknowledges this argument, it is still reluctant in including a similar provision in its MTC and has instead included an alternative provision in its Commentary.

Whilst the services permanent establishment has the effect of increasing source country jurisdiction to tax service fees, when compared to the traditional permanent establishment concept which places emphasis on the presence of a fixed place of business, the author contends that the 183 days-of-work threshold is too high especially in light of globalisation and electronic commerce which has made the remote provision of services possible. This is exacerbated by the requirement that the 183 days-of-work be calculated with respect to 'the same or connected projects'.

In addition to the above concerns, the author also notes that both the fixed place of business threshold and the days-of-work threshold are susceptible to abuse by taxpayers. In this regard, tax avoidance arrangements such as the fragmentation of activities between closely related parties and the splitting-up of contracts, have been used by taxpayer in avoiding the permanent establishment status.

In the author's view, the BEPS measures which have been formulated by the OECD in Action 7 to address the artificial avoidance of permanent establishment status are welcomed and would assist in preventing such tax arrangements. However, the author finds it regrettable that the OECD did not include in Action 7 measures aimed at lowering the permanent establishment threshold, as the current permanent establishment threshold has been identified as contributing towards the BEPS concerns faced by source countries in relation to service fees.[228] This issue, in the author's view, requires a drastic reform of the permanent establishment principle or new measures to help ensure that the source countries tax base, particularly those of developing countries, are not eroded as a result of cross-border service fee payments.

[227] Wichmann, M., note 169, p.202.
[228] UN Committee of Experts, note 28, pp.4-5 of Annex 2.

CHAPTER 5

Options for addressing the erosion of South Africa's tax base as a result of service fees

Chapter overview

5.1 Modifications to the permanent establishment threshold

5.1.1 Lowering the permanent establishment threshold

5.1.2 Introducing a virtual permanent establishment

5.2 Withholding taxes

5.2.1 Single-rate withholding approach

5.2.2 UN's Technical Fee article

Introduction

The aim of this chapter is to briefly consider some of the options which have been advanced as possible solutions for addressing the erosion of the source state's tax base as a result of service fees and to identify the solution which is appropriate for South Africa.

The options considered in this chapter are specifically aimed at addressing the challenges brought about by globalisation and electronic commerce which have the effect of enabling multinational enterprises to provide services in a source state with either no fixed place of business in the source state or with very limited physical presence therein and thus not creating a permanent establishment in the source state.

At issue is the fact that the service fees payable to these multinational enterprises are generally deductible by the payor in the source state whilst the corresponding income is not taxed in the source state thereby eroding the source state's tax base.

5.1 Modifications to the permanent establishment threshold

5.1.1 Lowering the permanent establishment threshold

Arnold proposes that Article 5 (and Article 7) be revised to allow source country taxation of income from services performed in the source country, even if the services are not performed through a fixed place of business in the source country but are performed there for a significant period.[229] In this regard, he makes the following recommendations:

- That the OECD alternative provision be included in Article 5 of the OECD MTC itself;
- He contends that the OECD alternative provision represents an improvement on Article 5(3)(b) of the UN MTC and thus, that Article 5(3)(b) of the UN MTC be replaced by adding a provision to Article 5 that is similar to the OECD's alternative services permanent establishment provision;
- 'The same or connected projects' requirement be deleted from the services permanent establishment provisions; and
- He recommends that consideration be given to reducing the days-of-work threshold under the services permanent establishment provisions in respect of business services to 90 or 120 days or to leaving the threshold to be determined by bilateral negotiations.[230]

5.1.2 Introducing a virtual permanent establishment

The virtual permanent establishment approach is a policy approach which has been advocated by Hinnekens.[231] Pinto explains that this approach seeks to relax the permanent establishment principle

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[229] Arnold, B.J., note 71, p.24.
[230] *Ibid.*
[231] Pinto, D., note 1, p.276.

by adopting a threshold for source-based taxation that is lower than that of a traditional permanent establishment:

> It achieves this by creating a tax nexus in source countries even in the absence of a fixed place of business in them. This effectively means that the tax nexus operates as a permanent establishment "fiction" by allowing tax jurisdiction on the basis of a virtual permanent establishment in the source country.[232]

According to Skaar, source countries should seek to include permanent establishment fictions in their bilateral treaties for industries where high mobility, impermanence, and the lack of physical location are predominant.[233]

Pinto states that this approach contains two main elements.[234] First, a lower threshold for a permanent establishment is intended to apply in the case of electronic commerce transactions, and this is achieved by deleting the requirement for the existence of a "fixed place of business" in the source country from the current formulation of source under the permanent establishment threshold.[235] Second, core or mainstream business activities are subject to source-country taxation under the approach, while ancillary activities are not.[236]

Hinnekens argues that the above modification would redesign the traditional permanent establishment concept to accommodate electronic commerce transactions in a way that taxes these transactions consistent with the principles of economic allegiance and equivalence.[237] Such an approach could also represent a compromise between the interests of electronic commerce exporting and importing countries, thereby achieving the sharing of revenue between these countries.[238]

However, Pinto notes that the likely problems in trying to establish an internationally acceptable standard for determining the tax nexus under this approach loom as a major factor which detracts from its successful implementation.[239] Further, Pinto notes that these problems are exacerbated by the likely difficulties that will be encountered in attributing profits to a virtual permanent establishment.[240]

In the author's view, a nexus based on the concept of significant economic presence, as formulated by the OECD in its Final Report on Action 1, could be used as a standard for determining the tax nexus under the virtual permanent establishment approach.[241]

The OECD explains that this option would create a taxable presence in a country when a non-resident enterprise has a significant economic presence in a country on the basis of factors that would evidence a purposeful and sustained interaction with the economy of that country via technology and other

[232] *Ibid.*
[233] *Ibid.*
[234] *Ibid.*
[235] *Ibid.*
[236] *Ibid.*
[237] Pinto, D., note 1, p.279.
[238] *Ibid.*
[239] Pinto, D., note 1, p.277.
[240] *Ibid.*
[241] OECD, note 78, p.109.

automated tools i.e. the so-called digital permanent establishment.[242] These factors, which may be digital factors or user-based factors, would be combined with a factor based on the revenue derived from remote transactions into the country, in order to ensure that only cases of significant economic presence are covered, limit compliance costs of the taxpayers, and provide certainty for cross-border activities.[243]

The author also notes that the OECD explored several methods for determining the income which would be attributable to the digital permanent establishment in its Final Report on Action 1. The methods considered included maintaining the existing rules and principles, methods based on fractional apportionment or modified deemed profit methods.[244] Based on the findings in the Final Report on Action 1, it appears that a modified deemed profit method would be the more preferred method for determining the profit to be attributable to the digital permanent establishment.[245] Likewise, the author considers that this method could also be considered for the virtual permanent establishment approach.

5.2 Withholding taxes

5.2.1 Single-rate withholding approach

The single-rate withholding approach is aimed at addressing the challenges created by electronic commerce.[246] According to Doernberg this approach seeks to address two main concerns created by electronic commerce:

> First, electronic commerce importing countries are concerned that they may lose some of their existing tax base and/or will not be able to share in any new tax base generated by electronic commerce transactions. Second, taxpayers and governments are concerned about the likelihood of double taxation because of inconsistencies in the application of existing tax principles to income generated by electronic commerce.[247]

The four essential features of the single-rate withholding approach are:

- The single-rate withholding approach is intended to operate within the existing international tax regime, including maintaining the permanent establishment principle. However, the single-rate withholding approach seeks to modify the application of the permanent establishment principle to allow source and residence countries to share the tax base generated by electronic commerce transactions.[248]
- Under the single-rate withholding approach, source countries are permitted to withhold tax at a single rate on any payment that has the effect of 'eroding' the country's tax base. In this regard, a payment would be considered as eroding the source country's tax base if it was either deductible by a source-country purchaser or formed part of his cost of goods sold (as

[242] *Ibid.*
[243] OECD, note 78, pp.109-111.
[244] OECD, note 78, pp.113-115.
[245] *Ibid.*
[246] Pinto, D., note 1, p.275.
[247] *Ibid.*
[248] *Ibid.*

this would decrease the gain on the sale of goods). If either of the conditions are fulfilled, withholding would occur under the single-rate withholding approach irrespective of the category of income. Pinto notes that this feature is intended to respond to the concern regarding the characterisaction problems that are likely to intensify in electronic commerce transactions, as the test for withholding would be independent of the characterisation of the income in the transaction. One of the notable exceptions to withholding under the single-rate withholding approach is that payments made by consumers of source countries would not be subject to withholding because consumers do not generally deduct the costs of their consumption.[249]

- The withholding tax is intended to be creditable in the residence country, as the approach is premised on allocating the tax base from electronic commerce between source and residence countries, rather than increasing the overall level of taxation. Pinto states that this feature is designed to achieve an allocation of the tax base between residence and source countries and to also operate as a mechanism to avoid double taxation.[250]
- The final feature of the single-rate withholding approach is the inclusion of a mechanism to allow vendors from residence countries to file on a net basis in source countries. Pinto explains that this feature is necessary to overcome the potential excessive tax burden that may be associated with a gross-based tax under the proposal, along with concerns of double taxation.[251]

Regarding the rate to be applied in the single-rate withholding approach, Pinto recommends that any chosen rate should be low in order to accommodate the commonly expressed concern that, from an economic perspective, a gross-based tax may conceal a much higher net rate of tax.[252] Additionally, Pinto states that, as the tax base under the single-rate withholding approach is more comprehensive than is currently the case for withholding tax systems, a low rate of tax seems appropriate.[253]

5.2.2 UN's Technical Fee article

The UN has also formulated a new Technical Fee article which seeks to impose a withholding tax on fees of a technical, managerial or consultancy nature.[254]

This new article, which will be included in the next update of the UN MTC as Article 16, is built on the base erosion approach and accordingly allows the source country to tax any fees for technical services made by residents of the source country (and non-residents with a permanent establishment or fixed base in the source country) to residents of the other country, irrespective of whether the services are rendered inside or outside the source country.[255] The Technical Fee article therefore allows the

[249] *Ibid.*
[250] *Ibid.*
[251] *Ibid.*
[252] *Ibid.*
[253] *Ibid.*
[254] UN Committee of Experts, note 28, p.2.
[255] UN Committee of Experts, note 28, p.1 of Annex 2.

sharing of technical fees between the country of residence of the service provider and the country in which the payment or income arises.

The UN Committee of Experts state in the Draft Commentary on the Technical Fee article that the majority of the committee members rejected the position that a State should be entitled to tax income from services derived by a resident of the other Contracting State only if the services are performed in the first State:

> In particular, they rejected the argument that the residence of a payer of fees for technical services in a Contracting State and the deduction of those fees against that State's tax base do not provide sufficient nexus to that State to justify that State taxing those fees. In the view of those members of the Committee, base erosion is a sufficient justification for the taxation of income from employment under Article 15 and directors' fees and remuneration of top-level managerial officials under Article [17]. Although taxation of employment income under Article 15 is limited to employment exercised in a country, Article [16] allows a Contracting State to tax an individual resident in the other Contracting State on fees derived by the individual as a director or remuneration derived as a top-level managerial official of a company resident in the first State, irrespective of whether the services are rendered inside or outside the first State. Moreover, under Articles 7 and 14, a country is entitled to tax income derived outside the country as long as the income is attributable to a permanent establishment or fixed base in that country.[256]

The salient features of the Technical Fee article are:

- The source country is limited to taxing technical fees on a gross basis at a rate to be determined pursuant to negotiations between the Contracting States.[257]
- It is subject to the provisions of Articles 8 (Shipping, inland waterways transport and air transport), 16 (Director's fees and remuneration of top-level managerial officials) and 17 (Artistes and sportspersons).[258]
- The term 'fees for technical services' excludes any payment made to an employee of the person making the payment; for teaching in an educational institution or for teaching by an educational institution; or by an individual for services for the personal use of an individual.[259]
- Additionally, to the extent that the technical fees are attributable to a permanent establishment or fixed base situated in the country in which the technical fee arises, the Technical Fee article will not apply. Instead these fees will be taxed under either Article 7 or 14 as the case may be.[260]

The UN Committee of Experts justify the inclusion of this article in the UN MTC on the basis that the rapid changes in modern economies, particularly the advancements in means of communication and information technology, have made it possible for an enterprise resident in one State to be substantially involved in another State's economy without a permanent establishment and without

[256] UN Committee of Experts, note 28, pp.6-7 of Annex 2.
[257] UN Committee of Experts, note 28, p.1 of Annex 1.
[258] *Ibid.*
[259] *Ibid.*
[260] *Ibid.*

any substantial physical presence in that State thereby avoiding tax on the technical fees derived in that State.[261]

The UN also mentions the need to clarify the application of Article 12. This stems from the fact that some countries take the view that the expression 'information concerning industrial, commercial or scientific experience' in Article 12 includes certain technical services and thus seek to tax fees for technical services under Article 12.[262] The UN notes that the uncertainty concerning the treatment of fees for technical and other similar services under its current provisions is undesirable for both taxpayers and tax authorities and may have led to difficult disputes between taxpayers and tax administrators.[263]

However, the main reason for the inclusion of the Technical Fee article relates to the BEPS concern. The UN notes that fees for technical services generally result in the erosion of the tax base of the source state as these fees are deductible against the source state's tax base if the payer is a resident of the country (or a non-resident with a permanent establishment or fixed base situated therein) whilst the source state may be prevented from taxing such fees under a double tax treaty.[264] As a result, multinational enterprises sometimes use fees for technical services to strip the profits of their subsidiaries.[265]

For countries who are worried that the scope of the Technical Fee article is too broad, the Draft Commentary to the Technical Fee article provides two alternative options for taxing fees for technical services:

(i) That Article 12 be amended to permit taxation of certain 'fees for included services'. The Draft Commentary to the Technical Fee article states that this approach is found in a number of bilateral tax treaties between developing and developed countries. The underlying policy rationale for this narrower approach is that, in order to justify taxation by the State from which the payment is made even in cases when the services are not performed in that State, fees for services must be directly related to the enjoyment of property for which a royalty as otherwise defined in Article 12 is paid;[266] or

(ii) The Technical Fee article is amended to apply to all fees for services performed in a Contracting State and, in respect of fees for services performed outside that State, only if the services are performed by related persons.[267]

As noted in Chapter 3 of this dissertation, several double tax treaties, particularly those concluded by developing countries (including South Africa), already incorporate a Technical Fee article. A survey

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261 UN Committee of Experts, note 28, pp.1-2 of Annex 2.
262 UN Committee of Experts, note 28, pp.2-3 of Annex 2.
263 UN Committee of Experts, note 28, p.4 of Annex 2.
264 *Ibid.*
265 UN Committee of Experts, note 28, pp.4-5 of Annex 2.
266 UN Committee of Experts, note 28, p.10 of Annex 2.
267 UN Committee of Experts, note 28, p.11 of Annex 2.

conducted by the IBFD in 2011 identified 134 of the almost 1,600 tax treaties concluded between 1997 and 2011 as containing a separate article dealing with fees for technical services.[268]

The author observes that there are subtle differences between the UN's Technical Fee article as compared to the Technical Fee articles contained in the double tax treaties entered into by South Africa. For instance, the Technical Fee articles in the South African double tax treaties do not explicitly state that the provisions of the Technical Fee article are subject to the provisions of Articles 8, 16 and 17. However, in general, the structure and format of the UN's Technical Fee article and the Technical Fee articles contained in the South African double tax treaties are almost identical.

Conclusion

There are a number of solutions which have been advanced by scholars, the UN and the OECD alike in addressing the 'deficiencies' of the existing rules for the taxation of services in light of the sophisticated manner in which services are provided in this modern age (through the aid of globalisation and e-commerce). These options are, to a certain extent, a mere permutation of the options analysed in this chapter. The author therefore considers that the options which have been analysed in this dissertation represent a fair sample of the available options for addressing the concerns related to the taxation of service fees.

The common factor in the options considered in this chapter is the underlying objective of extending the source state's taxing rights with respect to service fees such that the source state is either afforded more taxing rights with respect to service fees arising within its geographical borders and/or such that the source state obtains a share of the service fees generated from services provided through electronic commerce.

In the author's view, Option 1 does not suffice as a viable option for addressing the 'deficiencies' of the existing rules for the taxation of services. Whilst this option will indeed extend the source state's taxing rights to services which are otherwise not physically rendered in the source state (if the services are performed in the source state for a significant period), it will still deny the source state taxing rights in respect of services provided through electronic commerce or any services whose nature enables it to be rendered to the source state through very minimal physical presence therein, if such physical presence is below the days-of-work threshold.

The author notes that Option 1 may potentially be effective if it is supplemented by Option 2, or by any other solution similar to that suggested in Option 2. In this case, Option 1 would serve to address services which are to a certain degree provided physically whilst Option 2 would then address services provided through electronic means. However, the author contends that the aforementioned proposal, although theoretically sound, is likely to be burdensome for taxpayers and difficult for tax authorities to administer as (i) it would require taxpayers to maintain a financial recording system which allows them to track services provided electronically versus services provided physically, in addition to tracking services provided per jurisdiction; (ii) in relation to Option 2, the author is of the view that

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[268] Wijnen, W.F.G., de Goede, J.J.P. & Alessi, A., note 77, p.33.

any international standard that may be agreed on for determining the tax nexus for the virtual permanent establishment is likely to be very complex for both taxpayers seeking to establish whether they have created a taxable presence in a certain jurisdiction or for tax authorities seeking to either administer taxes or identify anti-avoidance cases; and (iii) profit attribution under Option 2 is likely to be difficult.

In addition to the concerns raised above on Option 2, Yariv and Baez Moreno, argue that a nexus based approach may fail once its direct reliance on actual physical presence is broken:

> The difficulties faced by the agency PE and service PE concepts are indicative of the difficulty in establishing the even more innovative digital PE notion. Moreover, expansion of PE taxation to digital transactions may raise the question of the logic and desirability of using different PE thresholds in different industries. This question is particularly acute once the OECD has decided that it would not "ring-fence" the digital economy. Furthermore, even if a nexus-based approach is taken, one must discuss its implementation. The difficulty of simply attributing profits to a non-physical PE and the opposition of the OECD to formulary taxation ... may require a remedial tool, such as a withholding tax to adequately implement the nexus-based approach in the digital economy.[269]

Based on the above, the author considers the withholding tax options as the more appropriate solutions for addressing the 'deficiencies' of the existing rules for the taxation of services, especially in light of globalisation and electronic commerce. In the author's view, the advantage of the withholding tax solutions advanced in this chapter over Options 1 and 2 (or a combination thereof), is that the withholding tax solutions do not contain any threshold requirements; they target both services provided physically and electronically; and they would eliminate any concerns relating to the artificial avoidance of permanent establishment status.

The author also notes that one of the concerns associated with service fees, is that such fees contribute towards the erosion of the source state's tax base.[270] The author therefore contends that any solution which seeks to address the taxation of service fees, particularly service fees arising from services provided electronically, should have as one of its main objective, the prevention of the erosion of the source state's tax base. Thus, the author considers Options 3 and 4 as appropriate solutions as they are based on the base erosion approach.

However, the author is inclined to favour Option 3 over Option 4 for the following reasons:

- Unlike the Technical Fee article which applies to services of a technical, managerial or consultancy nature, the single-rate withholding approach applies to any payment that has the effect of eroding the country's tax base. Thus, Option 3 has a much broader application, ensures that standard withholding tax rules apply across all payments subject to a withholding tax and also eliminates any issues relating to the interpretation of the terms, 'technical', 'managerial', or 'consultancy' services.

[269] Brauner, Y. & Baez Moreno, A., 2015. Withholding taxes in the service of BEPS action 1: address the tax challenges of the digital economy. *WU International Taxation Research Paper Series No. 2015 – 14*. Available: https://www.ibfd.org/sites/ibfd.org/files/content/WithholdingTaxesintheServiceofBEPSAction1-whitepaper.pdf [25 February 2018].

[270] UN Committee of Experts, note 28, p.4 of Annex 2.

- The withholding taxes applicable under the single-rate withholding approach are not a final tax. Thus, a taxpayer has an option to file on a net basis in the source country, as opposed to the Technical Fee article where the withholding tax is a final tax. The issue with imposing a final tax, without an option to file on a net basis, is that the taxpayer is (i) denied the deduction of legitimate expenditure incurred in the production of the income; and (ii) in certain cases, a final tax may lead to double taxation where the residence state's remedies for relieving double taxation are not adequate to fully relieve the gross-basis taxation imposed by the other State.

Solution for South Africa

Following the arguments above, the author considers that a withholding tax approach would be an ideal solution for South Africa. The author substantiates this conclusion with the following additional arguments:

- In the author's view, Option 1 or 2 would be undesirable from a South African perspective owing to South Africa's concern that a number of foreign entities are avoiding the permanent establishment status through not filing their tax returns.[271] As both Options 1 and 2 would still require a foreign entity to perform its own analysis as to whether it had created a permanent establishment in South Africa, the trend to avoid the permanent establishment status is likely to continue. In this regard, the author contends that the current Reportable Arrangements Notice is not an adequate tool for identifying foreign entities who might potentially have a permanent establishment in South Africa as it contains a threshold requirement (R10m) which means that payments below that threshold would go undetected. Thus, a foreign entity could avoid the Reportable Arrangements provisions through the splitting-up of service contracts, such that the service fee payment under each contract is below the threshold.
- The author also notes that South Africa's ability to tax service fees under Option 1 may be limited due to South Africa's 'main or dominant cause' approach for determining the source of service fees, as well as the Income Tax legislation's silence on the permissibility of apportionment, which may render certain service fees to be foreign-sourced even though a portion of the services were physically rendered in South Africa.
- In the author's view, any solution modelled on either Option 3 or 4, would be preferred from a South African perspective. Firstly, a withholding tax system ensures that tax is collected from the payor, which is within the country's legal jurisdiction, should the foreign recipient attempt to avoid its tax obligations. The other benefits of a withholding tax system include the reduction of compliance costs for taxpayers as taxpayers won't be required to file an annual tax return and early collection of tax by the government.[272]
- The author also notes that Options 3 and 4 are based on the base erosion approach. In the author's view, the benefit of having a withholding tax system for service fees based on the base erosion approach, is that it would address South Africa's concern that cross-border service

[271] Explanatory Memorandum, note 3, pp.75-76.
[272] Holmes, K., note 67, p.9.

fees are contributing towards the erosion of its tax base.[273] Additionally, such an approach will eliminate any concerns relating to the determination of the source of service fees, particularly the 'main or dominant cause' approach, as the withholding will be based on the residency of the payor versus the place where the services are performed.

Notwithstanding the author's preference for Option 3 (expressed earlier in this document), the author recommends that South Africa negotiates the inclusion of Option 4 in its double tax treaties as this option is consistent with the Technical Fee articles already contained in some double tax treaties entered into by South Africa. Alternatively, South Africa should continue negotiating for the inclusion of the existing Technical Fee article in more of its double tax treaties.

The author contends that Option 4 (or the existing Technical Fee article), which does not seek to modify the permanent establishment threshold but instead seeks to supplement it, will expand South Africa's taxing rights with respect to service fees arising from technical services, whether or not the services are physically rendered in South Africa. This option will simultaneously address South Africa's concern that service fees are contributing towards the erosion of its tax base by targeting all service fees which are paid by South African residents (or non-residents with a permanent establishment or fixed base in the source country) as opposed to looking at the place where services are performed.

[273] Explanatory Memorandum, note 3, p.75.

CHAPTER 6

Summary of findings and overall conclusion and recommendations

Chapter overview

6.1 Research objectives

This dissertation sought to demonstrate that the permanent establishment threshold is no longer appropriate for the taxation of service fees and, as a result, contributes towards the erosion of the source state's tax base. In addition, the dissertation considered various options for addressing this concern and provided a recommendation as to the option most suitable for South Africa.

It was stated that the dissertation will be guided by the following objectives:

- Theoretical foundations and rationale for source-based taxation;
- A brief overview of South Africa's domestic tax law, with a special focus on the taxation of service fees;
- A critical analysis of Article 5 of the OECD and UN MTCs; and
- Options for addressing the erosion of South Africa's tax base as a result of service fees.

The aim of this chapter is therefore to provide a summary of the findings of this research and overall conclusion and recommendations.

6.2 Findings

A number of developing countries, including South Africa, have expressed a concern regarding the threat to the erosion of their tax base due to outward cross-border service fees. This is as certain of the services such as management and consultancy services rendered by multinational enterprises often involve large sums of money. Whilst these services generally result in local deductions, the income derived by the multinational enterprises is seldom taxed in the source state. It is observed that globalisation and electronic commerce has made the remote provision of services possible. Thus, it has become common for multinational entities to render services in the source state with minimal physical presence therein, thus avoiding creating a permanent establishment. This calls into question the appropriateness of the permanent establishment threshold.

From the research conducted, it was found that-

- The theoretical foundations and rationale for source-based taxation, such as the benefit theory, equity, neutrality, entitlement and the base erosion principle, justifies the taxation of service fees in the source state, irrespective of the period spent in the source state physically rendering the services.
- The term 'service fees' is not defined in South Africa's Income Tax legislation and the source of service fees is determined with reference to common law. In this regard, the inference that can be drawn from the Lever Brothers case is that the originating cause for income from services rendered is the services rendered and such income is located where the services are rendered. Where income arises due to more than one originating cause, recognition is given only to the main or dominant cause.
- It is also noted that our Income Tax legislation does not cater for the apportionment of income.

- In order for a non-resident to be subject to corporate income tax in South Africa on service fees derived therein, the service fees must be attributable to the non-resident's permanent establishment as defined under the OECD or UN MTCs.
- South Africa has successfully negotiated for the inclusion of the Technical Fee article in certain of its double tax treaties. However, this article currently has no effect as South Africa's domestic legislation does not enable the withholding of tax on service fees.
- It was also found that the permanent establishment threshold, as currently defined, is no longer appropriate for the taxation of service fees. Specifically, the 'fixed place of business' threshold and the 183 days-of-work threshold are too high resulting in service fees escaping tax in the source countries and consequentially leading to the erosion of the source countries' tax base. The inappropriateness of the permanent establishment threshold is exacerbated by its susceptibility to manipulation by taxpayers seeking to avoid the permanent establishment status.
- Various options were considered for addressing the above issues associated with the existing rules for the taxation of services and a recommendation was made that South Africa should negotiate for the inclusion of the UN's Technical Fee article, or the existing Technical Fee article found in its double tax treaties. Such an article will have the effect of extending South Africa's taxing rights with respect to service fees and will also address the base erosion concerns associated with service fees.

6.3 Overall conclusion and recommendations

As the global service sector continues to grow and the means through which these services are provided becomes increasingly sophisticated, it is imperative that South Africa implements laws that seek to tax service fees in an efficient, effective and equitable manner. Notwithstanding this, South Africa, as a net importer of services[274], also has to ensure that it implements laws which seek to protect its tax base from erosion particularly relating to service fees.

The findings of this dissertation have demonstrated that the permanent establishment threshold is no longer appropriate for the taxation of services in light of globalisation and the advent of electronic commerce. Specifically, the permanent establishment threshold is too high and as a result, enables multinational enterprises to avoid creating a permanent establishment in the source state and thus to avoid tax on the service fees derived therein. This consequently leads to the erosion of the source state's tax base.

In order to overcome the above concerns, a drastic reform of the existing tax rules for the taxation of service fees is required. In this regard, any new rules formulated for the taxation of service should seek to extend the source state's taxing rights with respect to service fees and also to address the base erosion concerns. In the author's view, the solution presented by the UN, in the form of the Technical Fee article, achieves this objective.

[274] Developing countries are generally capital importing countries. Holmes, note 67, p.59.

The author therefore recommends that South Africa negotiates for the inclusion of the UN's Technical Fee article (or the existing Technical Fee article found in its double tax treaties). Such an article would extend South Africa's taxing rights with respect to service fees and also alleviate the base erosion concerns associated with service fees. However, the Technical Fee article will only yield the desired results if it is supported by a domestic provision which enables the withholding of tax on technical fees. Thus, the author calls for the re-instatement of the domestic withholding tax on service fees.

The author notes that certain of South Africa's double tax treaties, although minimal, already contain the Technical Fee article. The author therefore contends that South Africa is losing out on additional tax revenue that could be generated from service fees paid by South African tax resident entities (or non-residents with permanent establishments situated in South Africa) to companies which are tax resident in countries with which South Africa has concluded a double tax treaty containing the Technical Fee article.

The author further rejects the arguments which were advanced by industry against the implementation of the withholding tax on services regime and argues that such arguments are without merit. In particular, the author contends that:

- The withholding tax on service fees is in line with international norms. This can be seen by the number of countries (over 150) whose domestic regime imposes a withholding tax on technical and management fees paid to non-residents.[275]
- The author contends that the administrative burden for South African taxpayers associated with outbound service fees under the withholding tax on service fees regime would be far less onerous than the current Reportable Arrangements obligation.
- A withholding tax on service fees regime will also provide certainty to foreign investors whereby they will know upfront what their tax exposure is on service fees versus incurring consulting costs in an effort to determine whether they have created a permanent establishment in South Africa.
- The author supports the comments made by the UN in its Draft Commentary on the Technical Fee article where it states that countries should be aware of the possibility that fees for technical services may be grossed up in the same way that they should be aware of the possibility of similar grossing up with respect to interest and royalties under Articles 11 and 12 respectively.[276] In the author's view, instead of using the gross-up argument as a deterrent against the introduction of a withholding tax on service fees, it should instead encourage discussions as to the appropriate withholding tax rate.
- The withholding tax on service fees regime will also ensure that South African service providers are not overly prejudiced by being subjected to corporate income tax at 28% on service fees whilst the non-resident service providers are not being taxed at all. In this regard, the author notes an argument by Holmes suggesting that such prejudice often induces

[275] Foster, M.C., 2014. Withholding tax on services: a square peg in a round hole? – an analysis of intra-group cross border services in the context of source, related transfer pricing principles and withholding taxes. MCom (International Tax). Thesis. University of Cape Town.
[276] UN Committee of Experts, note 28, p.7 of Annex 2.

domestic investors to restructure their affairs and to invest in their country via offshore intermediaries.[277]

[277] Holmes, K., note 67, p.11.

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Annexure A

Summary of Double Tax Treaties (in force) entered into by South Africa as at 6 October 2017

Africa

No.	Country	Services permanent establishment provision	Technical fees	Days-of-work threshold	Comments
1	Algeria	✓		More than six months	
2	Botswana	✓	✓	More than 183 days	
3	Cameroon	✓	✓	More than 183 days	
4	Democratic Republic of Congo	✓		More than 183 days	
5	Egypt	✓		More than 183 days	
6	Ethiopia	✓		More than six months	
7	Ghana		✓		The double tax treaty between South Africa and Ghana contains a Management Fees article. Management fees are defined in this double tax treaty as payments of any kind to any person, other than to an employee of the person making the payments, in consideration for any services of a managerial, technical or consultancy nature.
8	Kenya	✓		More than 183 days	
9	Lesotho	✓	✓	More than 90 days	
10	Malawi				
11	Mauritius	✓		More than 183 days	
12	Mozambique	✓		More than 180 days	
13	Namibia	✓		More than six months	
14	Nigeria	✓		More than 183 days	
15	Rwanda	✓	✓	More than 183 days	
16	Seychelles	✓		More than 183 days	
17	Sierra Leone				
18	Swaziland	✓	✓	More than 90 days	
19	Tanzania	✓		More than 183 days	
20	Tunisia		✓		
21	Uganda		✓		
22	Zambia				
23	Zimbabwe	✓	✓	More than 183 days	

Rest of the world

1	Australia				
2	Austria				
3	Belarus	✓		More than 120 days	
4	Belgium				
5	Brazil		✓		Technical fee provision incorporated in Article 12
6	Bulgaria	✓		More than 183 days	
7	Canada	✓		More than 12 months	
8	Chile	✓		More than 183 days	
9	China	✓		More than 12 months in any 24 month period	
10	Croatia	✓		More than 183 days	
11	Cyprus				
12	Czech Republic	✓		More than six months	
13	Denmark				
14	Finland				
15	France				
16	Germany				
17	Greece	✓		More than 120 days	
18	Grenada				
19	Hong Kong	✓		More than 183 days	
20	Hungary				
21	India		✓		Technical fee provision incorporated in Article 12
22	Indonesia	✓		More than 120 days	
23	Iran	✓		More than six months	
24	Ireland				
25	Israel				
26	Italy				
27	Japan				
28	Korea				
29	Kuwait	✓		More than six months	
30	Luxembourg				
31	Malaysia	✓	✓	More than 183 days	
32	Malta	✓		More than six months	
33	Mexico	✓		More than 183 days	
34	Netherlands				
35	New Zealand	✓		More than 183 days	
36	Norway				
37	Oman	✓		More than 90 days	
38	Pakistan	✓	✓	More than six months	Technical fee provision incorporated in Article 12

39	Poland				
40	Portugal				
41	Qatar	✓		More than 183 days	
42	Romania				
43	Russian Federation				
44	Saudi Arabia	✓		More than six months	
45	Singapore	✓		More than 183 days	
46	Slovak Republic				
47	Spain				
48	Sweden				
49	Switzerland				
50	Taiwan				
51	Thailand	✓		More than six months	
52	Turkey				
53	Ukraine	✓		More than six months	
54	United Arab Emirates	✓		More than nine months	
55	United Kingdom				
56	United States of America	✓		More than 183 days	

Total	**42**	**13**